CARRYOVER OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF CORPORATIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

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CARRYOVER OF NET OPERATING LOSSES AND OTHER TAX ATTRIBUTES OF CORPORATIONS

WEDNESDAY, MAY 22, 1985

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room H-137, the Capitol, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. The subcommittee will come to order.

Today the Subcommittee on Select Revenue Measures is scheduled to hear from interested parties on the subject of the carryover of net operating losses and other tax attributes of corporations.

In the Tax Reform Act of 1976, the Congress attempted to restrict trafficking in net operating losses. Those 1976 provisions have proved complex and controversial, and the effective date has changed four times in the last 8 years. They are presently scheduled to become effective on January 1, 1986.

Since 1976, numerous alternative proposals have been advanced which would restrict, in varying degrees and by varying methods, the free transfer of net operating losses and other corporate tax attributes.

The subcommittee has invited testimony today on three alternative approaches: One, the retention of present law with possible modifications to deal with transactions which may escape limitation; two, retention of the 1976 amendments, with any necessary modifications to help simplify these rules; and, three, application of a new set of limitations.

Continued postponement of any resolution of this issue is a source of frustration for policymakers, tax planners and practitioners. Consequently, I hope that today's hearing will lead to a long-delayed and much needed final resolution of this important tax policy issue.

Now, there are many people who have requested to testify today and so we have tried to accommodate as many people as possible. Your written statements will be included in the record in full, and I am asking unanimous consent that the press release announcing this hearing be placed in the record at this time.

[The press release announcing the hearing follows:]

[For immediate release, Wednesday, May 1, 1985]

HON. CHARLES B. RANGEL, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS

The Honorable Charles B. Rangel (D., N.Y.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, announced today a hearing on the carryover of the net operating losses and other tax attributes of corporations. The hearing will be held on Wednesday, May 22, 1985, beginning at 9:30 a.m. in H-137, the Capitol.

In announcing the hearing, Chairman Rangel stated, "The limitations on net operating loss carryovers of corporations which were enacted in the Tax Reform Act of 1976 have been delayed four times in the last eight years. In the interim, numerous alternative proposals have been advanced by various professional groups and other interested parties. Having considered many different approaches to this issue during this period, it is time for legislative action. The continued postponement of a resolution of this issue is a source of frustration both for business planners and tax practitioners as well as tax policymakers. Consequently, I am hopeful that the subcommittee hearing will lead to a long-delayed final resolution of this important tax policy issue."

BACKGROUND

Present law net operating loss provisions

Present law Code section 382 terminates or reduces net operating loss carryforwards of corporations in certain cases after a significant change in ownership of the loss corporation. Loss carryforwards are terminated if, during a two-year period, the 10 largest shareholders of a loss company purchased 50 percent or more of the loss corporation's stock and the corporation has failed to carry on a trade or business conducted before the change in ownership (the purchase rule). Loss carryovers are reduced following an acquistion of the assets of one corporation by another in a statutory merger and certain other tax-free reorganizations if the former shareholders of a loss corporation participating in the reorganization have an interest of less than 20 percent of the stock in the surviving corporation following the reorganization (the reorganization rule). The reduction is five percent of the loss carryforwards for each one percent by which the continuing interest of the former loss corporation shareholders falls below 20 percent. The reduction applies whether or not any business conducted by the loss corporation is continued.

The 1976 Tax Reform Act revisions of code section 382

Concern with the difference in treatment of loss carryforwards under the purchase rule as compared with the reorganization rule, the difficulty of interpretation, as well as doubt about the policy of the business continuation requirement under the purchase rule, and failure of the rules to cover certain forms of acquisition resulted in a revision of the rules in the Tax Reform Act of 1976. The 1976 Act revisions impose a parallel reduction in loss carryforward under the purchase rule and the reorganization rule if, in either case, the continuing ownership of the loss company shareholders falls below a 40-percent threshold. The reduction is proportional with further changes in ownership after the threshold is reached. Under the purchase rule, the 15 largest shareholders (rather than the largest 10) are counted, the period over which the ownership change is tested is increased from two to three years, and the reduction in loss carryforwards applies whether or not the corporation continues to carry on a trade or business conducted before the ownership change. Certain transactions not subject to the pre-1976 (present law) rules result in reduction of carryforwards under the 1976 revisions, principally (1) acquisitions of control by contributions to the capital of a loss company in exchange for stock, (2) certain acquisitions through partnerships owning stock in a loss company, (3) reorganizations in the form of tax-free exchanges of stock for loss corporation stock, and (4) certain reorganizations where stock issued to loss corporation shareholders is stock of a corporation controlling the acquiring corporation. Under the 1976 Act revisions, the change in ownership is determined with reference to all the stock, or all the stock participating in earnings and assets, whichever results in the greater ownership change.

Criticism of the 1976 Act revisions has led Congress to postpone their effective date four times. Under present law, the revisions are scheduled to become effective on January 1, 1986.

SCOPE OF HEARINGS

In view of the December 31, 1985, expiration date of the delay in implementing the 1976 Act revisions, the Subcommittee invites testimony on the following alternative approaches:

1. Present law section 382 could be retained, with or without modification expanding the scope of the rules to deal with transactions that escape the limitations imposed by present law.

2. The 1976 Act revisions to section 382 could be permitted to become effective on January 1, 1986, as present law provides. Consideration could be given to modifications to simplify these rules and eliminate technical defects.

3. A new set of limitations.

Witnesses are invited to comment on these alternative approaches, and with respect to present law section 382 or the 1976 Act revisions, on modifications that may be appropriate to make the rules more effective and less complex. The Subcommittee wishes to emphasize that each witness should be prepared to address issues raised with respect to each of the three alternative approaches which the Committee might consider. Comments with respect to the treatment of built-in losses and built-in gains are also invited.

Details for submission of requests to be heard

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard in writing no later than close of busniess Wednesday, May 15, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for members to question witnesses. In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 100 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearances. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

Requests to be heard, prepared statements to be presented in person, and statements filed for the printed record of the hearing, must contain the following information:

1. The name, full address, and capacity in which the witness will appear, as well as a telephone number where the witness or a designated representative may be reached;

2. A list of any clients or persons, or any organization for whom the witness appears; and

3. A topical outline or summary of comments and recommendations.

Written statements in lieu of personal appearance

Persons submitting written statements for the printed record of the hearing should submit at least six (6) copies by the close of business, Wednesday, June 5, 1985, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. (See other requirements enumerated above.) If those filing written statements for the record of the printed hearing wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the hearing begins.

Chairman RANGEL. I want to point out that while it is not usual that we follow the 5-minute rule, because of the large number of witnesses and the shortness of time, I hope the witnesses will not embarrass themselves and make me feel uncomfortable by having to interrupt their testimony. So please limit the oral statements to 5 minutes, and we will be able to fully understand through the record the position of the witnesses.

Our first witness today is Mikel Rollyson, and I thank you for your patience in this matter. We are prepared to receive your testimony.

STATEMENT OF RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, AS PRESENTED BY MIKEL M. ROLLYSON, DIRECTOR, OFFICE OF TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. ROLLYSON. Thank you, Mr. Chairman. I will keep my statement brief.

I want to note that Assistant Secretary Pearlman was scheduled to testify this morning, but he was taken ill early this morning and, therefore, I am filling in for him today.

As you mentioned in your opening remarks, we do want to talk about the adequacy of existing law and some of the proposed amendments thereto. The 1976 amendments have now been around for almost 10 years. Current law, I think, is thought by all to be somewhat deficient. These rules have been delayed over the last 8 to 9 years, and we do believe that we will be able to enact new proposals that would be effective on January 1, 1986, and we are very eager to work with the committee in formulating those rules.

By way of background, let me just say a few words about net operating loss carryovers generally. Historically and under current law, net operating losses and credits, and I will refer only to net operating losses for convenience, can be generally carried back 3 years and carried forward 15 years. The principal rationale for this is for the losses to be utilized as an averaging device to offset the rigors of the annual accounting system under which we operate.

There are in general several ways in which the net operating losses are preserved. Typically, on an acquisition of stock, the net operating losses do survive and are not terminated. Similarly, with respect to a tax-free reorganization, the net operating losses typically survive. If there is, however, a section 338 election following a stock acquisition by purchase, the net operating losses would be terminated.

Section 382 came into the code in 1954 to limit trafficking in net operating losses; to put limitations on the instances in which those carryovers would survive. Section 382 basically has two alternative rules. A purchase and a redemption rule under which NOL's are either completely terminated or survive completely, which is triggered only when there is, one, a greater than 50-percent change in ownership and, two, a discontinuation of the old trade or business. In other words, under the current 382 purchase rule, even though 100 percent of the stock ownership changes hands, no limitations are placed on the carryover of net operating losses until the old business is discontinued.

Now, the 1976 act amendment would tighten those rules significantly. It would drop the business continuity requirement and would focus solely on changes in shareholder ownership. In addition, the threshold change of ownership would be raised from 50 to 60 percent and the all or nothing effect of old 382 would be replaced with a phaseout rule so that the net operating losses would be phased out between 60 and 100 percent change of ownership.

Second, there is a separate reorganization rule which tests carryover of the net operating losses by a 20-percent continuity of interest. The 1976 amendments would essentially expand the reorganization rule to catch a lot of transactions which now escape that provision and also increase the ownership requirement from 20 up to 40 percent.

In formulating these rules, we must consider, whether or not any limitations are appropriate on the carryover of net operating losses. I think it is fair to say any such limitations will create economic distortions. There will be a tendency for conglomeration. There will also be a discrepancy between the treatment of old corporations and new corporations.

Nevertheless, despite these somewhat problematic economic distortions and the neutrality that might result from complete free transferability of NOL's or from a refundability approach to NOL's, we do not believe it is appropriate at this time for the Federal Government to be subsidizing all such investments or to become a partner in all potential investors. Therefore, we do not favor refundability nor do we favor free transferability of net operating losses.

We do believe, however, that the current section 382 rules, even as beefed up by the 1976 amendments, are flawed in that they look to the continuity of shareholder interest tests. The rationale for looking at shareholder continuity is that those are the shareholders who incurred the economic loss and it should be those shareholders who receive the benefits of those losses in future years. Thus, when shareholder ownership changes, the losses should be in some fashion limited.

The problems with this approach are that, No. 1, it is somewhat inconsistent with the averaging notion. No. 2, the net operating losses may not in fact represent true economic losses. They may be as a result of specific incentives contained in the Internal Revenue Code, and this system measuring carryovers solely by reference to shareholder interest creates economic distortions. Moreover, it creates a bias against acquisitions by large corporations.

In light of these deficiencies with respect to the current law, even as amended by the 1976 act, we would like to work with the committee to develop rules along the lines suggested in the ALI proposal. The basic rule provided by the ALI proposal is that all net operating losses would survive an acquisition, but the rate at which those losses could be utilized would be limited. Basically, the limitation would be based upon an assumed income stream that would have been produced by the loss corporation. The effect of this rule essentially is that the income-averaging notion on which net operating loss carryovers are premised would be retained. We think the economic distortions created by current law would be significantly reduced and that the role of the net operating losses in mergers and acquisitions would be diminished by adopting such a rule.

There have been a number of alternative variations on the ALI approach that have been suggested. We would suggest a simplified approach providing a single rule applicable to both purchases and reorganizations. The ALI proposal would technically propose two different rules.

An important issue that must be considered in respect to this rule is the assumed income stream against which the net operating losses can be utilized, what can be referred to as the absorption rate. By and large, several methodologies have been proposed to measure this income stream. We could look at the rate at which loss corporations typically utilize NOL's. We could look more generally to the rate at which all corporations earn income, or we might look at a market rate of return on the assumption that any corporation could always liquidate its assets, invest in marketable securities and use those earnings to offset the net operating losses. Each of those three approaches does have pluses and minuses, and we think the committee should consider each of those approaches very carefully.

In the press release, you specifically asked about the treatment of built-in gains and losses. In general, we believe that built-in losses are the economic equivalent of net operating losses and that some limitation ought to be imposed upon those built-in losses. Similarly, however, any built-in gains should be available to offset built-in losses.

I think the critical feature with respect to built-in gains and losses is that a simplified approach be adopted with relatively generous de minimis rules so that taxpayers would not be tied up continually trying to evaluate the level of every built-in gain and every built-in loss that may exist.

That briefly summarizes my testimony for you this morning, Mr. Chairman, and I will be happy to respond to any of your questions.

[The prepared statement follows:]

STATEMENT OF RONALD A. PEARLMAN, ASSISTANT SECRETARY (TAX POLICY), DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of the Subcommittee, I am pleased to appear before you today to present the views of the Treasury Department on the limitations imposed by the Internal Revenue Code on the extent to which a corporation can utilize net operating loss carryovers, excess tax credits, and other tax attributes following corporate transactions. The Subcommittee has scheduled this hearing to consider the adequacy of the limitations imposed by existing law and to explore alternative methods of formulating the applicable limitations. The existing limitations were amended extensively by the Tax Reform Act of 1976 ("1976 Act"), but the effective dates of those amendments have been delayed repeatedly in response to criticism. The 1976 Act amendments are currently scheduled to become effective on January 1, 1986.

There is general consensus that the current operative limitations are inadequate and in need of revision. The merits of the 1976 Act amendments have been debated for almost ten years. The Treasury Department strongly believes that appropriate limitations should be developed before January 1, 1986, and commends the Subcommittee for conducting this hearing. We hope to work actively with the Subcommittee in its effort to develop a clear and workable set of rules in this area.

BACKGROUND

Under current law, a corporation that incurs a net operating loss in one year generally is permitted to use the loss to offset income earned in the three taxable years prior to and the fifteen years after the year in which the loss is incurred. The underlying premise of allowing a corporation to offset a net operating loss incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system. For similar reasons, corporation that are unable to use all their credits against tax in the year in which the credits are earned may use such excess credits to offset tax liability in the three prior and fifteen succeeding taxable years.

The tax attributes of a corporation, including net operating loss carryovers and excess credit carryovers, generally survive an acquisition of the corporation, because the corporation's tax history is not affected if its corporate status is unchanged. Thus, if a person purchases the stock of a corporation in a taxable stock acquisition, the corporation's tax attributes generally are preserved, unless an acquiring corporation makes a section 338 election. Thus, the ability to use the net operating loss carryovers of an acquired corporation to offset income earned by that corporation in the fifteen years after the loss typically is not affected by the stock purchase. If a section 338 election is made, however, the taxable stock acquisition shares most of the characteristics of a taxable asset acquisition from a liquidating corporation, including the fact that the acquiring corporation does not succeed to any of the target corporation's tax attributes. Finally, if a corporation is acquired by another corporation in a tax-free acquisition, the Internal Revenue Code provides that the tax attributes of the target corporation carry over to the acquiring corporation, notwithstanding the fact that the acquired corporation's separate corporate existence may terminate.

Section 382 was added to the Internal Revenue Code in 1954 primarily to establish objective tests that would curb "trafficking" in corporations with unused net operating losses.[1]

Congress was particularly concerned that profitable corporations were acquiring shell corporations whose principal asset was a net operating loss carryforward that could be applied in future years against income unrelated to any business activity of the acquired corporation.[2]

In the 1976 Act, Congress sought to tighten and unify the provisions of section 382. The 1976 Act amendments were enacted in part because Congress believed that section 382 as enacted in 1954 was ineffective and did not adequately serve its purpose. The effective dates of the 1976 Act amendments, however, have been delayed repeatedly in response to criticism, and are currently scheduled to become effective on January 1, 1986.

Section 382, both as presently in effect and as modified by the 1976 Act, incorporates two sets of rules for limiting the utilization of net operating losses. One set of rules applies in cases of changes of stock ownership by purchase or redemption and the other set of rules applies to acquisitions by tax-free reorganization.

Purchase rule

Under existing section 382, in the case of redemptions and acquisitions by purchase, no carryover of net operating losses is permitted if (1) more than 50 percent of the stock of the corporation that incurred the loss ("loss corporation") changes ownership within two taxable years and (2) the loss corporation does not continue to carry on substantially the same trade or business after the change in stock ownership. The determination of whether 50 percent of the loss corporation's stock has changed ownership is made with reference to the ten largest shareholders. Thus, in a transaction in which a corporation's stock is sold or redeemed, the carryover of net operating losses is prohibited if there is both (1) insufficient "continuity of interest" by the loss corporation's shareholders and (2) insufficient "continuity of busi-

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[1] A similar set of rules is provided in section 383 to limit the use of corporate tax attributes other than net operating losses, such as investment tax credit carryovers, foreign tax credit carryovers, and capital loss carryovers. For convenience, we will refer in our discussion primary to net operating loss carryovers. Many of the same principles, however, apply to other corporate tax attributes.

[2] In addition to the objective limitations contained in sections 382 and 383, the carry over of net operating losses and excess credits may be disallowed under section 269 if the principal purpose of an acquisition of a corporation is to secure the benefit of the net operating loss or excess credits. Thus, section 269 serves as a backstop to prevent misuse of the general carryover limitation provisions. In addition to these statutory limitations, the ability of an acquiring corporation to benefit from the tax attributes of a target corporation by joining with the target to file a consolidated income tax return is limited by the "separate return limitation year" and "consolidated return change of ownership" rules provided in applicable Treasury regulations. The consolidated return regulations under certain circumstances also limit the ability to benefit from "built-in" losses following an acquisition. Finally, limitations also may be imposed under certain situations by operation of a judicially-crafted continuity of business enterprise test. In *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1975), the Court held that net operating loss carryovers would not survive a statutory merger unless the losses were offset against income earned after the merger that was attributable to the same business that produced the loss. While Libson Shops arose under the 1939 Code, its applicability under existing law is unclear. The legislative history of the 1976 Act amendments, however, provides expressly that the continuity of business enterprise concept articulated in Libson Shops will not survive the effective date of those amendments.

ness enterprise" after the transaction. If either of these conditions does not occur, however, the use of net operating loss carryovers following a stock purchase or a redemption are not subject to any limitations. Thus, for example, all the stock of a corporation may be sold without invoking any limitations under section 382 if the new owners continue the loss corporation's historic business.

The 1976 Act amendments tightened the limitations applicable to taxable acquisitions by removing the requirement that the historic trade or business of the loss corporation be terminated before limitations on carryovers would be imposed. Thus, under the 1976 Act amendments, the limitations are triggered solely by reference to changes in stock ownership. These amendments also raised the threshold change of stock ownership to 60 percent in the case of stock purchases, increased to 15 the number of relevant shareholders, and lengthened the "lookback" period. The increase in the threshold from 50 percent to 60 percent was enacted to coordinate the rules applicable to purchases with those applicable to reorganizations, described below. In addition, rather than eliminating all net operating losses once the required change in stock ownership occurred, net operating loss carryovers under the 1976 Act amendments are gradually phased out as the percentage change in stock ownership increases from 60 percent to 100 percent.

Reorganization rule

Under section 382 as presently in effect, the carryover of net operating losses generally is limited in the case of certain tax-free reorganizations if the stock in the acquiring corporation that is received by shareholders of the loss corporation after the acquisition represents less than 20 percent of the stock of the surviving corporation. In such a case, the net operating loss carryovers of the loss corporation are gradually reduced based upon the level of the loss shareholders' ownership in the surviving corporation. It is irrelevant for purposes of the reorganization rule whether the acquiring corporation continues to conduct the trade or business of the loss corporation.

Under the 1976 Act, the types of tax-free reorganizations to which section 382 applies were expanded significantly to prevent avoidance of the limitation. This expansion cured one of the most glaring deficiencies in the current limitations. The limitations applicable to tax-free reorganizations also were strengthened further by increasing from 20 percent to 40 percent the level of stock ownership at which net operating loss carryovers would be limited. Thus, if the shareholders of a loss corporation received at least 40 percent of the acquiring corporation's stock, the net operating losses would be allowed in full. If, on the other hand, the loss corporation's shareholders acquired less than 40 percent of the stock of the acquiring corporation in such a tax-free reorganization, the net operating losses available to the acquiring corporation would be phased out as the loss corporation shareholders' percentage ownership in the surviving corporation declined. As in the case of taxable purchases and redemptions, the limitations applicable to tax-free reorganizations under the 1976 Act amendments turn solely on changes in stock ownership.

DISCUSSION

Before discussing proposals to change the applicable limitations, it is useful to outline briefly the theoretical underpinnings of the limitations on the carryover of net operating losses and other tax attributes following the acquisition of a corporation. We also will describe generally the criticism that has been made in response to existing law and the 1976 Act amendments.

Basic principles

In analyzing the issues raised by the carryover of corporate net operating losses, commentators have suggested the following competing, and somewhat inconsistent, tax and economic policy considerations: any rule governing the carryover of tax attributes should be consistent with the historic legislative purpose of the carryover provisions as averaging devices; the tax laws should not distort investment decisions and should not create undue bias between diversified and non-diversified entities or between old and new businesses; a corporation's ability to carry over net operating losses should not require the Federal government to be a partner in all businesses. In other words, the rules governing the use of net operating losses should not amount to a Federal subsidy for all such losses; the rules applicable to the carryover of tax attributes should prevent "trafficking" in loss corporations; any limitations on the carryover of net operating losses and other tax attributes should not result in tax attributes of a corporation becoming more or less valuable in the hands of a purchaser of the corporation than they would have been in the hands of the seller; the tax laws should not encourage corporate acquisitions that would not be under-

taken on purely economic grounds or discourage those that would be undertaken on such grounds; the rules establishing limitations on carryovers also should provide certainty in determining the extent to which tax attributes will survive an acquisition to prevent a purchaser from obtaining a windfall from the carryover.

Refundability

As is apparent from these principles, the initial question that must be faced is whether any limitations should be imposed on the use of net operating losses. One can argue that the rules governing the use of net operating losses will not create a bias among various types of entities and businesses and will not distort investment decisions only if all limitations are removed from the utilization of such losses. The furthest move in this direction would be to provide for refundability of net operating losses. In a refundability system, a corporation that incurred a net operating loss would receive a refund from the Federal government equal to the tax savings that would have resulted if the corporation had been able to offset fully the net operating loss in the year incurred against other income.

A provision for direct reimbursement of net operating losses by the Federal government would, of course, eliminate the need for limitation provisions such as section 382. Moreover, such a system would ensure that the benefits of a net operating loss would accrue directly to the entity that suffered the loss.

The adoption of a refundability system also would eliminate the current bias in favor of conglomeration that exists with respect to the deductibility of net operating losses. This bias exists because net operating losses of one business may be offset against profits of another business, thereby reducing the conglomerate's current tax burden. By comparison, a corporation engaged in a single line of business does not receive any tax benefit from a net operating loss until and unless the corporation realizes offsetting income. On a present value basis, such a net operating loss is worth less than a net operating loss that is usable currently. A reimbursement system would eliminate this bias by providing the same after-tax consequences for a net operating loss regardless of the existence of a related profitable enterprise.

Similarly, the current treatment of net operating losses is biased in favor of established enterprises, with respect to new investment. An established corporation that incurs a loss on an investment may secure an immediate refund under current law by applying that loss against past taxable profits. A new corporation, by contrast, is unable to utilize a net operating loss until it realizes taxable income. A system of refundability would eliminate this bias by equalizing the tax benefits of losses to new and existing businesses.

While a system of refundability might well make the net operating loss provisions more neutral among various types of enterprises, the Treasury Department does not believe it is advisable to implement such a system. A system of refundability would require the Federal government to become a partner in all investments, a role we believe is inappropriate. Moreover, a system of refundability would pose potentially insurmountable administrative and budgetary problems. For example, verification of the bona fide value of the net operating losses would be imperative, yet extremely difficult, complex and, perhaps, impossible.

Free trafficking

Short of providing direct government reimbursement of net operating losses, one can argue that all limitations on the carryover of tax attributes from one corporation to another, including section 382, should be repealed. Under such a system, profitable corporations would be free to purchase net operating losses from loss corporations. While this free trafficking in corporations with favorable tax attributes would not achieve complete neutrality, it would ensure that most of the benefit of the net operating losses would be realized by those who suffered the economic losses. Consequently, purchasers of loss corporations would not be able to realize windfall profits at the expense of loss corporations or their shareholders.

Unrestricted trafficking in loss corporations, however, would constitute partial and indirect reimbursement of losses. As stated above, we do not believe that the carryover rules were intended to serve the function of providing Federal subsidies, whether direct or indirect, for corporate losses.

We also believe that unrestricted trafficking in loss corporations would go far beyond the legislative purpose underlying a corporation's right to offset a net operating loss incurred in one year against taxable income earned in another year. This right is intended merely as an averaging device to reduce the inequity of a strick annual accounting system.

Although we recognize that both refundability and the unrestricted trafficking in loss corporations might make risk-taking in corporate form more attractive, it is not clear that risk-taking is relatively discouraged under existing tax rules. The unre-

stricted ability to use corporate tax attributes, including net operating losses, also would encourage the takeover of loss corporations by profitable corporations primarily to obtain the tax benefits of net operating loss carryovers. Purely tax-motivated mergers and acquisitions would have adverse effects on the economy and should not be encouraged.

Alternate bases for limitations

Accepting, as we do, that it is appropriate to place some limitations on the use of net operating loss carryovers following corporate acquisitions, it is necessary to examine both the triggering events that make any limitations operative and the mechanics of the limitation. The principal triggering events that have been used in the past are continuity of shareholder interest and continuity of business enterprise. The limitation has taken the form of either complete disallowance or partial reduction of the amount of net operating loss carryovers that survive the triggering events.

For purposes of section 382, continuity of shareholder interest may be defined as the continued economic interest of the shareholders of the loss corporation in that corporation or its successor during the taxable years subsequent to the years in which the net operating losses were incurred. Since its enactment in 1954, section 382 has considered continuity of shareholder interest a significant factor in determining whether, and the extent to which, the carryover of net operating losses should be limited. Moreover, the 1976 Act amendments to section 382 established continuity of shareholder interest as the sole factor to be considered in determining whether and the extent to which net operating loss carryovers survive a change in ownership of the loss corporation.

The rationale for using continuity of shareholder interest as the basis for limiting carryovers is that a corporation's shareholders generally are the real parties who suffer economic loss when the corporation they own incurs a net operating loss. Thus, the loss carryover should be deductible by the corporation only if such a deduction will reduce the shareholders' economic loss.

We believe that reliance on continuity of shareholder interest to determine the extent to which carryovers survive a corporate acquisition, particularly the sole factor as set forth in the 1976 Act amendments, is flawed for several reasons. First, a limitation based on continuity of shareholder interest may be inconsistent with the income averaging function of the net operating loss carryover provision. For example, net operating losses under current law may result from a corporation's ability to deduct expenses prior to the year in which corresponding items of income must be reported. This mismatching of income and expenses most frequently occurs in the case of assets that are subject to the accelerated cost recovery system. To the extent that net operating losses result from this mismatching of expenses and income, rather than from economic losses, the lack of continuity of shareholder interest should not unduly restrict the ability of the business to use its net operating losses to offset income in subsequent taxable years.

Moreover, a loss limitation rule that reduces available net operating losses by reference to a specified percentage of continued shareholder interest, such as the reorganization rule in existing law and the 1976 Act amendments, may create undesirable economic effects. For example, if shareholders of the loss corporation are required to own a minimum percentage of the stock of the surviving corporation following a tax-free reorganization, then acquisitions by relatively large corporations will be discouraged. In particular, the larger corporations would be denied the use of otherwise available net operating loss carryovers, and would thus be economically motivated to offer less consideration for the loss corporation than would a smaller potential acquirer. Certain acquisitions might thus be discouraged, even though desirable without regard to tax considerations. We do not believe that the limitations on the use of net operating loss carryovers should bias acquisitions in favor of smaller companies or penalize larger companies.

The second event upon which the limitation on the carryover of net operating losses has been based is continuity of business enterprise. Under the continuity of business enterprise test, limitations on the carryover of net operating losses are triggered if the business previously conducted by the loss corporation is not continued by the acquiring corporation. This approach is intended to restrict use of net operating loss carryovers to the business activities that produced the losses.

The continuity of business enterprise doctrine, as a test to determine the availability of net operating loss carryovers, also suffers several serious flaws. First, the continuity of business enterprise test is difficult to apply whenever significant new capital or other assets are added to the old business, or where the old business is operated in a different manner. This uncertainty has resulted in costly and time-

consuming litigation without clarifying the ambiguous nature of the standard. In addition, it has caused purchasers of loss corporations to reduce the price they pay and has given them an opportunity to realize a windfall profit at the expense of the loss corporation and its shareholders. Thus, the intended beneficiaries of the carryover provisions, those who suffered the loss, do not properly benefit from the carry over of the net operating losses by the acquiring corporation.

Second, using continuity of business enterprise as a triggering event for limitations on the utilization of net operating loss carryovers encourages a loss corporation, or a corporation that purchases a loss corporation, to continue operating an unprofitable business. Such economic behavior should not be encouraged by the tax laws.

Third, even if the continuity of business enterprise test is met, the continuing business may be an insignificant part of the surviving corporation or produce no income, yet the net operating losses incurred prior to an acquisition in some cases can be used in full to offset income from other activities. Such a result, which in the extreme will be tantamount to free transferability of net operating losses, is unsatisfactory.

The existing rules of section 382, which rely on both continuity of business enterprise and continuity of shareholder interest, suffer the same defects as their theoretical underpinnings. Moreover, we believe that existing law is deficient because many corporate acquisitions can be structured to avoid the application of the limitations in situations in which there may be no substantial business purpose other than utilization of the net operating loss carryovers of the acquired corporation. For example, the limitations imposed by section 382 do not apply to stock acquisitions described in section 368(a)(1)(B). The limitations also may be avoided by acquiring control of a corporation through the use of a subsidiary in a triangular reorganization. While section 269 may curtail the use of the acquired corporation's net operating losses following such acquisitions under certain circumstances, existing section 382 inadequately serves its purpose when its provisions can be so easily avoided.

Finally, existing law is subject to deserved criticism because of its inconsistent treatment of acquisitions by taxable stock purchase and by tax-free reorganizations. For example, net operating loss carryovers are ratably disallowed in the wake of a tax-free reorganization in which there is insufficient continuity of shareholder interest, while the carryovers would be disallowed entirely if a purchase failed the requisite continuity of shareholder interest (assuming the historic business is not continued). In addition, section 382 distinguishes between purchase and reorganization transactions by applying the continuity of business enterprise test only to purchase transactions. Finally, the applicable thresholds on changes in ownership differ depending upon the type of transaction. We believe that the limitations on the use of net operating loss carryovers following purchase and reorganization transactions, which may be economically equivalent, should be consistent.

The 1976 Act, in an attempt to create a more effective set of rules, eliminated the continuity of business enterprise requirement for purchase transactions, further coordinated the treatment of acquisitions by purchase and tax-free reorganization, and tightened the rules significantly to prevent avoidance. While the rules enacted in 1976 addressed many of the principal defects of existing law, they have been criticized for their complexity. Although complexity in the laws should be avoided whenever possible, it is justified if the rules are necessary, theoretically correct, and effective. We believe, however, that the 1976 Act's reliance on continuity of shareholder interest to measure the extent to which net operating loss carryovers may be used following an acquisition is neither necessary nor theoretically correct.

Proposals for change

In view of the inadequacy of both existing law and the 1976 Act amendments, we would like to work with the Subcommittee in exploring possible alternative methods of limiting the utilization of net operating losses following certain corporate acquisitions. A principal alternative has been suggested by the American Law Institute that would set the limitations on net operating loss carryovers by reference to the amount of consideration paid for the loss corporation.[3] The basic principle of this approach, embodied generally in one set of rules for mergers and another set of rules for purchases, is that the entire net operating loss carryover should be preserved after a loss corporation is acquired, but a limit should be imposed on the amount of annual earnings against which the net operating loss carryovers can be deducted following the acquisition. The extent to which carryover may be used following an acquisition is based on the income stream from the loss corporation.

[3] See American Law Institute, Federal Income Tax Project, Subchapter C 198–290 (1982).

Under such an approach, the importance of net operating loss carryovers in acquisition decisions would be greatly diminished compared to existing law and the carryovers would be used after the acquisition at roughly the rate they would have been used if no acquisition had occurred.

Alternative formulations of the proper limitations, based generally on the American Law Institute approach, would limit the use of net operating loss carryovers, after both taxable purchases and tax-free reorganizations, to an amount based on the value of the loss corporation at the time of the acquisition. A significant virtue of this alternative is that a single rule could be applied to all types of transactions, a laudable attempt to simplify the applicable rules.[4] A limitation based on the value of the loss corporation could be formulated either to allow the use of pre-acquisition net operating loss carryovers, without regard to timing, in a total amount not exceeding the value of the corporation at the time of the acquisition or to allow such net operating loss carryovers to be used at a specified rate, based on the corporation's value, each year.

In our view, a simplified approach embodying a single rule is the preferred formulation of the limitations to be imposed on the carry over of net operating losses following both taxable stock purchases and tax-free reorganizations. We believe, however, that limiting only the total amount of net operating loss carryovers that would survive a purchase or reorganization is improper because such an approach would not impose any temporal limitation on use of the net operating loss carryovers and the losses could thus be deducted by the surviving corporation immediately following the acquisition. Consequently, we recommend that the Subcommittee adopt a single set of rules, modeled after the American Law Institute purchase rule, to limit the use of net operating carryovers following both taxable stock purchases and tax-free reorganizations.

Purchase rule

The purchase rule proposed by the American Law Institute would provide in general that in any case in which the ownership of the outstanding stock of a loss corporation changes by purchase after a loss year, the subsequent deduction of net operating loss carryovers would be limited. The limitation, as to both timing and amount, would be the income the loss corporation would have earned had no change of ownership occurred, assuming, importantly, that the loss corporation would begin to earn taxable income at a specified rate of return on the assets it owned at the time of purchase. In general, therefore, the approach would permit the net operating loss carryovers of the loss corporation to be offset against an amount of income earned after the purchase that is equal to a specified rate of return on the price paid for the loss corporation's asset. The purchase rule thus attempts generally to ensure that the net operating loss carryovers following an acquisition will be as valuable, but no more valuable, as they would have been if no acquisition had occurred.

The limitation of net operating loss carryovers would not be imposed unless more than 50 percent of the outstanding stock changed ownership after a loss year. Thus, although continuity of shareholder interest would no longer determine the extent to which net operating loss carryovers would survive an acquisition, the concept would remain as the applicable triggering event.

The 50 percent trigger threshold reflects the fact that although continuity of shareholder interest is generally an improper measure of the extent to which net operating loss carryovers should be available following a corporate acquisition, it may appropriately be used as a triggering event. In fact, the principal underlying premise of the carryover provisions—to provide an averaging device to ameliorate the harsh consequences of the annual accounting system—suggests that no limitations should be placed on a corporation's use of net operating loss carryovers simply because the corporation's stock has been sold. Indeed, the approach proposed by the American Law Institute reinforces this conclusion, as it would in theory permit net operating loss carryovers to offset any income earned after an acquisition that was allocable to the capital that produced the loss. Consequently, under this approach if new shareholders did not make additional capital contributions or otherwise attempt to augment the earning capacity of a loss corporation, no limitations on the post-sale use of the loss corporation's net operating loss carryovers would be necessary.

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[4] A single rule limiting the use of net operating loss carryovers following both taxable stock purchases and tax-free reorganizations has recently been proposed by the staff of the Senate Finance Committee. See Staff of Senate Committee on Finance, The Subchapter C Revision Act of 1985, A Final Report, Doc. No. 47, 99th Cong., 1st Sess. 244–255 (1985).

Although historic shareholders are permitted to contribute new capital to rehabilitate a loss corporation without invoking any limitations on the use of net operating losses previously incurred, purchasers of a loss corporation are not similarly permitted to contribute new capital and offset pre-acquisition net operating losses against income allocable to the new capital. Reflecting these premises, the purchase rule assumes that new shareholders will not make capital contributions or otherwise augment a loss corporation's earning capacity unless they hold at least a majority interest, and thus imposes no limitation unless 50 percent of the loss corporation's stock changes ownership. Once majority ownership changes hands, however, capital contributions or other attempts to increase earnings are assumed and the limitations are imposed.

If 100 percent of the stock of a corporation is purchased, the deduction of net operating loss carryovers for each subsequent taxable year would be limited in amount under the American Law Institute's purchase rule to an assumed rate of return times the value of the loss corporation's capital. If more than 50 percent but less than 100 percent of the loss corporation's stock were purchased, the portion of the acquiring corporation's income attributable to the stock that had not been sold could absorb net operating loss carryover deductions without limitation. The remaining portion of the earnings attributable to the stock that had been purchased could be offset only in an amount equal to the assumed rate times the portion of the capital that was transferred.

We believe that it is possible to achieve the goals of the purchase rule, while avoiding many of the problems raised by the relatively precise approach proposed by the American Law Institute, by limiting the net operating loss carryovers of the loss corporation that could be used annually following an acquisition to an amount equal to the total value of the loss corporation's stock at the time of the acquisition times an appropriate rate. The most important issue raised by such a rule is the determination of the appropriate limitation rate.

In order to ensure that the post-sale use of net operating loss carryovers would not be affected by an acquisition and that the value of carryovers would not be increased or decreased as a result of an acquisition, the theoretically correct limitation rate would be the rate at which the loss corporation would have used the net operating loss carryover if no acquisition had occurred. In our view, however, an administrable rule cannot meet this goal. Two approaches for approximating the theoretically correct rates have been suggested.

First, the limitation rate could be based on the average rate at which corporations actually absorb net operating loss carryovers. The measurement of this average absorption rate presents several difficulties. In particular, the decision would have to be made concerning the group of corporations that should be used to determine the average rate at which net operating loss carryovers are used.

Most loss corporations continue to experience losses and continue to increase, rather than absorb, their net operating loss carryovers. If this group of corporations were used to determine the average rate at which net operating loss carryovers are absorbed, the limitation rate would be set at or near zero.

A more generous assumption would be that all loss corporations that are acquired have "turned around," and experience, or are about to experience, taxable profits. Preliminary analysis indicates that, in 1981, corporations with taxable income that used net operating loss carryovers absorbed an average amount of such carryovers equal to approximately 5.5 percent of their book net worth.

An even more generous assumption would be that acquired loss corporations are not generally different from the average taxpaying corporation. Preliminary analysis indicates that the average absorption rate for all corporations was approximately 6.5 percent of book net worth in 1981.

In short, the average absorption rate approach suggests that the limitation rate should be in the range of zero to 7 percent. If, moreover, this rate were applied to the purchase price of the stock or another amount that similarly included the value of the corporation's tax benefits, rather than book net worth, the rate would have to be adjusted appropriately.

An alternative approach for setting the limitation rate would be based on a market interest rate. This approach, which was proposed by the American Law Institute, implicitly assumes that a loss corporation could have earned this rate on its assets and could, therefore, have absorbed its net operating loss carryovers at this speed. The loss corporation could obtain this rate of return, for example, by selling its assets and investing the proceeds in Treasury bonds.

The use of a market rate of return, however, might violate the principle that net operating losses should not become more valuable as a result of an acquisition in cases in which the loss corporation could not or would not earn a market rate on its

value. Nevertheless, the broad principal remains that if loss corporations have the option of earning a market interest rate on the value of their assets and offsetting their net operating loss carryovers against the resulting income, it may be appropriate to use this rate to determine the limitation on use of their net operating losses following an acquisition. Moreover, basing the limitation rate on a lower figure might cause a disparity between asset acquisitions and economically equivalent stock purchases.

Whether the limitation rate to be specified in a purchase rule is based on an average absorption rate or on a market interest rate, an adjustment to the rate is necessary to avoid double counting, assuming that the limitation, for administrative reasons, were based on the purchase price of the stock or the value of the corporation's equity. Because the purchase rule is designed to reflect the income that could have been earned by the corporation's productive assets and because the purchase price or value of the corporation's stock will reflect the value of the net operating loss carryovers and other tax attributes as well as the value of the assets, the limitation rate should be adjusted downward to eliminate the value of the net operating loss carryovers.

Merger rule

Under the pool of capital approach embodied in the American Law Institute's merger rule, in any case in which a loss corporation is acquired for stock of the acquiring corporation in a tax-free reorganization, the net operating loss carryovers otherwise available would generally be allowed to offset only the portion of income earned after the acquisition that is allocable to the contribution of the loss corporation's assets to the acquiring corporation. Such a merger rule is intended in principal to permit the use of a net operating loss carryovers to the same extent that such carryovers would have been allowed if the loss corporation and acquiring corporation had contributed all of their assets to a joint venture. The rule attempts to duplicate the fact that under such circumstances only the portion of the joint venture's income allocable to the loss corporation could be offset by that corporation's net operating loss carryover.

Although a merger rule is sound in concept, we question whether it could be applied effectively to reorganizations other than relatively simple ones. In light of such narrow applicability, we question whether the additional complexity created by the existence of two sets of rules is warranted. Moreover, we are concerned that the existence of two sets of rules creates the potential for inconsistent treatment of similar transactions. For these reasons, we believe it is appropriate to apply the purchase rule described above to all acquisitions of loss corporations.

New stock issues

The American Law Institute's approach generally would provide no limitation on the use of net operating loss carryovers if new stock is issued for cash or property by a loss corporation pro rata to shareholders who owned stock during the year in which the net operating loss was incurred. Moreover, no limitation would apply if such historic shareholders increased their interest in the fair market value of the loss corporation's stock by 50 percent or less. We agree that imposing no limitations on net operating loss carryovers in these situations is appropriate.

If a loss corporation issued new stock to third parties, however, the merger rule proposed by the American Law Institute would limit subsequent use of the net operating losses. Similarly, if a loss corporation issued new preferred stock to third parties, the income that could be offset against otherwise available net operating losses would be decreased by the total yield on such newly-issued preferred stock.

Although limiting subsequent use of net operating loss carryovers in cases in which contributions are made to the capital of the loss corporation is consistent with the underlying theory of the pool of capital approach, such a provision should be studied carefully prior to enactment. The proposed change would seem to encourage loss corporations to borrow capital, rather than to seek new equity. Moreover, such a rule might unduly discourage attempts to rehabilitate loss corporations, a pressure we believe should be avoided.

Built-in gains and losses

In the Subcommttee's press release announcing this hearing, testimony was specifically invited with respect to the treatment of "built-in" gains and losses. Built-in losses are generally defined to include any loss or deduction claimed with respect to an asset with a basis in excess of fair market value at the time of acquisition. The carryovers limitation rules contained in section 382, both as presently in effect and as amended by the 1976 Act, do not limit the post-acquisition use of built-in losses.

Assume, for example, that a purchaser acquired all of the outstanding stock of a corporation and did not continue to conduct the corporation's historic trade or business. In such a case, section 382 would completely disallow the corporation's use of pre-acquisition net operating losses carryovers. If, however, the corporation owned an asset with a fair market value of $100 and a basis of $300 on the acquisition date and later sold the asset for $100, the resulting $200 loss could be deducted by the corporation without limitation.

In the Treasury Department's view, a built-in loss is economically equivalent to a pre-acquisition net operating loss. Consequently, as reflected in the American Law Institute's proposal, the post-acquisition use of built-in losses should be subject to the same limitations as net operating loss carryovers and other favorable tax attributes.

Similarly, existing law affords no special treatment to corporate realization of built-in gains following a transaction that invokes the section 382 limitations on net operating loss carryovers. If, therefore, the stock of a corporation with appreciated assets and net operating loss carryovers were sold and the section 382 limitations were applicable, the income resulting from a sale of the assets would not be offset by the pre-acquisition net operating loss carryovers. While the resulting harshness of present law can sometimes be avoided by selling appreciated assets prior to a corporate acquisition, principles governing the proper measurement of income require that pre-acquisition net operating loss carryovers should be available to offset without limitation any income resulting from the realization of built-in gains.

We recognize that the treatment of built-in gains and losses described above would entail significant complexity. Most importantly, special treatment of built-in gains or losses would in many circumstances require detailed valuation of a corporation's assets. Consequently, if such special treatment is adopted, appropriate de minimis rules and simplifying assumptions must be carefully considered.

This concludes my prepared remarks. I would be happy to respond to any questions.

Chairman RANGEL. Thank you.

Two brief questions.

If we did follow the purchase price approach as proposed by the American Law Institute, how would you deal with the question of setting the rate of return?

Mr. ROLLYSON. Well, as I say, I think there are several alternatives. One approach, suggested by the ALI, would use a market rate of return. That would be a more generous rate of return than would be obtained if you looked to the actual experience of loss companies that utilize net operating losses. I think there are pluses and minuses with respect to each, and we have not taken a position in this testimony on which of the rules ought to be adopted.

The market rate of return is viewed as somewhat more generous, but the market rate of return would also, I think, produce better neutrality between alternative structuring of transactions. I think if we limit the utilization rate to the absorption rate for loss companies, there will be a significant strain upon the way in which acquisitions are structured.

Chairman RANGEL. It seems to me we can work more closely together when Treasury gives us what their firm recommendations are so that we will have an opportunity to have staff and the members review them. Then we can come back together.

Do you have any time frame at all as to when Treasury would be prepared to do that?

Mr. ROLLYSON. I think we are ready to begin working with the committee right away on this.

Chairman RANGEL. What I am suggesting is that the committee is ready and willing to work with you. But if you could give us your recommendations, I think that would be a better way to start the process.

Mr. ROLLYSON. I think we could do that on a very timely basis.

Chairman RANGEL. If a form of purchase rule is to be considered, do you have any ideas as to whether there should be limitation on the passive assets to be held by the loss corporation?

Mr. ROLLYSON. That is an issue that has been discussed over the last year, but which we have not discussed in this testimony. I think we would conclude that there probably should not be limitations on the passive assets held by corporations.

Chairman RANGEL. Well, you may, in your recommendations to the committee, have covered all of the issues and the questions that have been raised. But the quicker you get those to us, the quicker we then could raise other questions to you. And I am certain that we can then get together and at least have something that we can bring to the full committee.

Mr. ROLLYSON. Yes.

Chairman RANGEL. I thank you and share our condolences to Assistant Secretary Pearlman for his illness.

I am sorry. I did not see my dear friend.

Mrs. KENNELLY. No questions, Mr. Chairman.

Chairman RANGEL. Thank you very much.

I hope Mr. Pearlman is feeling better.

Mr. ROLLYSON. I am sure that he is. Thank you.

Chairman RANGEL. We will have a panel.

Richard Bacon from Bell, Boyd & Lloyd; John Ellingson, Bellevue, WA; Nicholas Tomasulo, Silverstein & Mullens, Washington, DC; and Dr. David W. LaRue, asssistant professor, McIntire School of Commerce, University of Virginia, Charlottesville, VA.

Thank you very much for your willingness to share your ideas on this very complex and important matter. For those of you who were not in the room when we opened the meetings, we will be following the 5-minute rule. But, at this time, without objections, your statements will be admitted into the record.

Mr. Bacon.

STATEMENT OF RICHARD L. BACON, ESQ., BELL, BOYD & LLOYD, WASHINGTON, DC

Mr. BACON. Mr. Chairman, I am an attorney in private practice in Washington. My reason for being here today is that I have been a member of the Joint Tax Committee staff, and, for better or worse, I was one of those who worked on the 1976 act amendments that you have been postponing and which, I guess, you are about to repeal.

My colleague, Nicholas Tomasulo, was also a member of the Joint Tax Committee staff going back to 1960, and also worked with Larry Woodworth.

In view of the complexity of this subject, which has been called the most hotly debated sore spot in the revenue laws, we decided to go back to the drawing board and see if the two of us who worked in this area as staff members, and then as practitioners, could come up with some practical set of rules that could bring a consensus together and finally deal with the problems that we are concerned with. We did propose something in an article in Tax Notes. Part of it is attached to my statement. And we have worked with

the American Bar tax section. I think, as you will hear from Mr. Lewis later, the basic elements of our proposal are the foundation of what the American Bar Association's tax section is proposing. It is a sound proposal to solve the problems in this area with some differences between their proposal and what I am going to suggest. But it offers us a consensus on which to solve the problems in this area. I would like tc summarize briefly what the proposal is and indicate some of the differences between what this proposal is and what Mr. Rollyson's version of it was on behalf of the Treasury Department.

We tried to understand what the basic problems are and to fashion a rule that will solve those problems. I would say that one of the underlying difficulties with the Treasury's rate of return limitation is that, in working in this area, we sometimes tend to develop technical solutions to things that are not problems. We should work the other way around and try to understand what we are trying to accomplish and then adopt the rule that will carry that out, rather than developing a solution to something that really does not solve any problem.

We want to prevent a situation in which somebody can look at a corporation that has $1 million in tax losses, buy the stock of the corporation for $100,000, and still get $1 million of tax losses. That is considered an abuse because the buyer could, at a 46-percent tax rate, save $460,000 in his taxes, and yet he only paid $100,000 for the company. That is the classic trafficking problem we are trying to prevent by this entire subject.

What we propose, or Nicholas and I propose, and what you will hear from the tax section, is a rule in which we would say that whenever anybody buys a loss company, he can get losses equal to what he pays for the company.

If you buy a company for $100,000, and it has $1 million of preexisting losses, the only losses the buyer can inherit are $100,000. So far as we are concerned, that is all the rule you need. You do not need any additional rate of return limitation on the buyer's use of a loss in any year.

Chairman RANGEL. Let me interrupt, because that makes a lot of sense, but you probably thought about this in 1976. Why was that not proposed in 1976?

Mr. BACON. The chief of staff of the Joint Tax Committee was Larry Woodworth at that time. You may remember, there were a lot of projects going on in the 1976 Tax Reform Act, and Larry's decision was that we did not have enough time to develop this fully, and it would be better to patch the loopholes in the existing law. That was all we tried to do in 1976 under the time pressures.

I would agree that there are pluses and minuses about the 1976 act version of section 382. On balance we probably should repeal it, because we have had 10 years to work on this simpler version. But Larry liked the purchase price idea in 1976. He felt the time pressures, however, and said just go patch the loopholes. That is what we did.

Chairman RANGEL. I did not raise the question to be critical of the decision, but to see whether or not you had thought about the approach you have recommended today, whether it was rejected then.

Mr. BACON. No. The purchase price proposal today actually had its origin in the predecessor to this committee, so we did not originate the idea. It originated back in 1958, when Mr. Mills and the predecessor of this committee hired a group of practitioners to make recommendations to your committee on changes in the corporate provisions of the tax law.

Mr. TOMASULO. They did not hire them. They worked free. Let me make that clear.

Mr. BACON. They proposed a version of this same rule, without any rate of return limitation such as Mr. Rollyson proposed. All of us who have worked in this area, including the tax section, have tried to modernize and update that basic proposal, and we recommend it to you today.

But I think you can use a much simpler version of what Mr. Rollyson has suggested, without going through this complicated rate of return limitation on the annual amount at which a buyer can use the losses equal to what the old owners probably would have been able to use each year. Once you limit a buyer to the amount that he pays for a company, I think you can see that no matter what the corporate tax rate is, no matter what business assets the new owner might put into the corporation, he can never come out ahead. If the corporate tax rate were, say, even 80 percent, and I paid $100,000 for a company that had $1 million of loss, I could save $80,000 in taxes by using the $100,000 of my carryover. But I still would have paid $100,000 and only saved $80,000. There is no possibility of anybody getting a tax benefit from a tax loss that exceeds the economic cost he incurred to buy the loss company.

Now, anything else that we might consider, such as limiting the annual rate at which a buyer can use the loss, is an artificial limitation that really prevents the new owner from turning around a business and being successful, if he can make a success out of the business which he has acquired.

I would add that our proposal does require that an owner acquire business assets, rather than mere passive assets. That is another difference between what we have suggested and what Mr. Rollyson has suggested.

As a fallback position, I would endorse a compromise proposal you will hear from the American Bar Tax Section for some limitation on the buyer's ability to use the losses immediately. They would put a 5-year stretchout on the buyer's ability to use the loss. But I do not think that is necessary for you to deal effectively with all the real problems, and prevent all the abuses, you are concerned about in this area.

Thank you.

[The prepared statement follows:]

STATEMENT OF RICHARD L. BACON, BELL, BOYD & LLOYD, WASHINGTON, DC

SUMMARY

1. If a 50% or greater change occurs in the stock ownership of a company having net operating loss or credit carryovers, the company should be allowed to use its own carryovers in an amount equal to (but no more than) the price paid by the new owner. This rule should apply regardless of whether the price is paid in stock, cash or notes, and regardless of whether the acquisition is taxable or taxfree to the selling shareholders.

2. The company should be allowed to use its carryovers under the above limit, without any further limit on the amount of carryovers that can be used in any one year after the merger. A "neutral" rule requires only that the buyer cannot acquire a loss company primarily for its tax benefits. If the general rule assures that the buyer must be primarily interested in business assets, no other potential abuses exist which justify any further limit on the rate of use of carryovers.

3. Exceptions to the proposed general rule should be made for creditor takeovers of a bankrupt or financially troubled company, and for supervisory mergers of defaulted savings and loan associations under regulation by the Federal Home Loan Bank Board.

STATEMENT

My name is Richard L. Bacon. I am a lawyer engaged in private tax practice in Washington as a partner in the law firm of Bell, Boyd & Lloyd. I am not appearing on behalf of any special interest or group. I was a member of the Joint Tax Committee staff in 1976 and, for better or worse, participated in developing the 1976 Act amendments to the loss carryover rules. I testified at this Subcommittee hearing in 1983 on the same subject we are considering today. I have been among a group of private practitioners who have devoted considerable time, inside the American Bar Tax Section and independently of the Section's formal work, toward developing a sensible set of rules for what happens to operating loss and credit carryovers after a loss company's stock ownership changes hands.

This subject has been called "the most hotly debated of the sore spots in the revenue laws." This description came from C. Rudolf Peterson, a member of an Advisory Group of tax practitioners who advised the Ways and Means Committee in 1958. All of us in this area have stood on the shoulders of those who have gone before. My colleague, Nick Tomasulo, and I proposed a single unified rule for loss carryovers in an article in Tax Notes for September 12, 1983. We reviewed and adapted a proposal by an Advisory Group to this Committee in 1958. The ABA Tax Section proposal adopts this same "purchase price" rule. A proposal by the Senate Finance Committee tax staff, I understand, works off the same basic idea, except that it adopts an extreme—and I believe unnecessarily restrictive—version of the same basic idea.

In most respects, all these proposals reflect a consensus over the basic type of approach to recommend to you. There are still some disagreements over some policies and details, however. These differences require real involvement on your part in deciding the basic policies to be adopted on this subject.

A. Basic policy decisions on loss carryovers are needed from members, and should not be delegated to the staff

Because of the disagreements in the area of carryovers, each tax lawyer, each professor, each tax staff member is, in a sense, his own philosopher-king. The issue of limiting tax attributes after a loss company's ownership changes hands is not a narrow, technical exercise. Some other technical matters fall, more or less, into this category, such as the changes you recently made in the installment sale rules and in the Subchapter S rules. The subject today is not in that category. Its importance and scope are such, I suggest, that they call for involvement in policy making at your level rather than being left to technicians, either inside or outside your staff.

We should look beyond proposed "solutions" which may be technically elegant, but which do not solve any real problem. We need your guidance on what the objectives should be in this area. Exactly what are we worried about by limiting loss carryovers after a merger? What do we want to consider an abuse?

Let's be sure we are clear on these basic matters before we accept or reject this or that "rule" that sounds as though it is a workable "solution" to something that may not be a problem.

B. Limits on carryovers should follow a middle-of-the road approach and avoid either extreme

Loss carryovers have been controversial because it is difficult to decide why we want limitations on the survival of attributes in the first place.

No limitations at all.—Some practitioners and scholars oppose any limitations on the theory that operating loss and credit carryovers are simply "assets" of a corporation, much like its buildings, machines or contracts, and the company should be allowed to negotiate a price for these tax benefits without any limitations at all. This is the "free trade" school of thought.

No carryovers at all.—At the other extreme are those who believes loss carryovers should not survive at all if a new owner takes control of a loss company. Those holding this view tend to say that if more than 50% of the stock of a company with

accumulated losses changes hands, the new owner should be treated as if he merely purchased assets alone. The loss carryovers should then disappear. This kind of approach basically challenges the whole category of taxfree reorganizations and approaches the idea that there should be no such category as a taxfree reorganization. It also ignores the case where new owners buy the stock of a profitable company; in that case, we want the accumulated earnings history to carry over to taint future distributions as fully taxable dividends.

Middle of the road approach.—The work done so far by your staff, and by academic study groups, on basic reform of corporate tax law has not so far proposed abolishing the entire area of taxfree reorganizations. We have felt so far that a taxfree acquisition, on the one hand, and a taxable acquisition, on the other hand, each carry a whole set of interrelated tax consequences. Both parties to a corporate acquisition should be allowed to make their deal by deciding which "package" of tax consequences they desire. (A taxfree reorganization brings over loss carryovers but it also brings over the old, low basis of the target company's assets—usually considered a disadvantage). So long as the tax results to both buyer and seller, and to the corporations involved, are consistent, and include both advantages and disadvantages, we have felt that it makes sense to allow the parties to choose between these two options, and not to abolish the existence of the options. It is sound policy to continue to allow these options.

Unless you decide to abolish the category of taxfree reorganization, I suggest we fashion a sensible set of limitations which assume that a corporate acquisition can be made on either a taxfree or a taxable format.

My views are as follows:

1. *Basic aims.*—The basic objective of loss carryover limitations should be to prevent a new owner from acquiring a loss company primarily for the sake of tax savings from use of the carryover of past operating losses and tax credits. On the other hand, carryovers should be allowed if they are incidental to an acquisition made primarily for nontax reasons.

The allowable amount of carryovers should not, however, exceed the probable earning power of the loss company's business assets at the time of the acquisition. A "purchase price" rule, described below, will achieve this result and assure that tax savings from loss carryovers can never exceed half the purchase price paid by the acquirer. Therefore, such a rule will assure that a buyer will acquire a loss company only if he pays more than half the purchase price for assets other than tax attributes.

2. *Limit carryovers to the purchase price paid by the buyer.*—An objective rule to accomplish the above results should allow the survival of carryovers up to (but no more than) the purchase price paid by the buyer, regardless of whether the consideration is paid in cash, notes, or stock. This single rule should apply to all 50% or greater changes in control of a loss company, whether by means of a taxfree reorganization, taxable purchase of the company's outstanding stock, transfer of money or property directly into a loss company in exchange for newly-issued stock, or redemption of a loss company's outstanding shares.

The rule would work this way: If a buyer pays $500,000 for the stock of a loss company, that company (or its successor if the deal takes the form of a taxfree acquisition of assets) could use only $500,000 of its loss carryovers. Since the maximum tax saving from the carryovers is 46%—or $230,000—the buyer in that case must be paying $270,000 for other nontax assets of the company. Otherwise, he could not profit by buying, at any price, a company having only loss carryovers. Notice that the tax benefit from the carryovers does not exceed 50% of the purchase price. The carryovers are, by definition, incidental to a primary acquisition of nontax assets.

The purchase price in these cases is really a present value summation of the income which the buyer expects to obtain from the company's business assets in the future and the tax benefits he expects to obtain from the carryovers in the future. In reality, a buyer will evaluate his ability to use tax losses in the same way he evaluates the potential earning power of the company's tangible assets. We cannot change this fact about the way a business deal is negotiated. What we should do as outside observers to a business deal is create a rule which will assure, in an objective fashion, that the new owners can use no more of the losses and credits than the loss company's business assets could have been expected to generate.

3. *No limit is needed on the annual rate of use of carryovers.*—Some staff proposals would allow the loss company to use its own carryovers annually only up to an interest-like return on the assets of the loss company at the date of the change of control. No such additional limitation is needed on the amount of carryovers which can be absorbed in any one year after a change in control.

4. *Meaning of a "neutral" rule.*—Loss carryover limitations should be "neutral" in the sense that they neither encourage nor discourage an acquisition, but allow a flow of tax history in an acquisition not prompted mainly to obtain tax savings. It is not necessary to go further and define "neutrality" by trying to allow a buyer the same rate of use of its carryovers which the loss company would have made under its former owners.

Such a narrow concept of neutrality would favor acquirers who have level, predictible income patterns and discourage others, and hence not be neutral in operation. The loss company should be allowed to use carryovers (up to the purchase price ceiling) in whatever amount it can absorb by business operations after the transaction. The ABA Tax Section proposal is second-best in this regard, stretching out the use of carryovers to no more than five years after the merger.

This point is discussed further later.

5. *Exceptions.*—Some exceptions to limitations on loss carryovers are appropriate for policy reasons. Among these should be: (a) supervisory mergers of savings and loan associations under supervision by the Federal Savings and Loan Insurance Corporation; and (b) cases where bona fide creditors of a bankrupt or financially troubled company agree to take stock in the company as a means of rehabilitating the business (in lieu of liquidating it entirely).

COMMENTS ON TWO CONTROVERSIAL ISSUES

In the general consensus which has developed around loss carryovers, at least within the ABA Tax Section, there are two technical issues in which debate is still taking place. These issues are: (1) whether an annual limit should be placed on the amount of carryovers a loss company can use after a change in control, and (2) whether any limits should be imposed requiring that a loss company be engaged in some sort of business at the time a sale occurs (as distinguished from being merely a passive investment company).

A loss company should not be treated as if it were a passive investment company

Some of those who have worked on alternatives in this area have convinced themselves that a new owner should not be allowed to use the allowed carryovers as rapidly as income can be generated to absorb them. One idea is to allow carryovers in an amount equal to the purchase price, but then limit the company to using no more of this amount in any year than the annual return it might have realized if it had converted all its assets to cash and invested that cash at a conservative rate of return. If the long-term Treasury Bill rate were used to determine this conservative return, the loss company could use no more than (at current rates) about 12% of the purchase price to absorb carryovers in any one year after the merger. This is supposed to be a good idea because it limits the new owner to using carryovers at the same annual rate as the old owners were supposedly able to use them.

This is an intellectual refinement we do not need to have equitable carryover rules and prevent abuses. The basic purchase price ceiling assures that a buyer will pay primarily for business assets; that is basically what we want him to do to prevent abuse of favorable tax attributes. I see no justification for going further and limiting the buyer's ability to use the allowed carryovers against income as fast as he can generate it after the sale. If new owners bring in fresh blood and fresh ideas and turn a failing business around, there is no reason not to allow the inherited tax history from being used against whatever income can be generated.

There is no inherent logic in wanting to limit a new owner's rate of using carryovers by how the old owners might have used them. Some staff members argue that limiting a new owner to the rate of use of losses which the old owners would have made is sound because, otherwise, carryovers close to expiring would be sold to high-income buyers who could use all the loss in the final years before the 15 year carryover period runs out. A loss carryover is just as deserving of being used in the 15th year as in the first year. So long as we are keying on business assets, we want a new owner to have an incentive to turn around a failing business quickly. A 12% ceiling on using carryovers in any year assumes that a corporation is just a vehicle for making passive investments. It is not; it is a vehicle for running a business. Businesses have ups and downs, and we should not adopt a rule for the company's tax history that treats it as if it were a passive investment company.

A rate of return limit will equate the new owner to the old owner, but this handicaps the new owner artificially. Let's keep focusing on basic policy. There is no reason we should want to limit a buyer's annual use of carryovers. If a healthy company were acquired, we do not want to limit dividends to only a yearly percentage of the inherited earnings and profits account. We should not treat net operating loss carryovers more harshly. You would also be creating a rule which encourages the

type of acquirers who have fairly stable and predictable income over a period of years. Acquiriers who have unpredictable or fluctuating levels of income, and who cannot predict from year to year how high or low their income is going to be, will be discouraged from making an acquisition because they cannot predict with certainty what the consequences will be over their business horizon.

Business Asset Test

A second issue is whether the loss company should be required to engage in some sort of generic business before and after an acquisition, or whether it is enough that a loss company owns merely cash (or cash equivalent) assets, including passive investment assets, at the time of acquisition.

My main concern is that cash and cash equivalnets are fungible assets. They operate in effect to reimburse the buyer for part of the price he pays for the loss company. If the buyer is reimbursed, he is actually paying less for the loss company than otherwise appears. Under the purchase rule, the carryovers should be allowed only in the amount of the economic, out-of-pocket cost to the buyer net of reimbursements to the buyer.

For this reason, Mr. Tomasulo and I have suggested that the purchase price, for purposes of this rule, be reduced by cash and cash equivalents owned by the loss company at the date of sale. (An allowance for working capital should be made under this rule, but in an amount that might be limited to a stated percentage of the purchase price paid by the buyer.)

The Senate tax staff comes at this same idea from a different direction, by proposing that the loss company must have at least ⅓ business assets at the date of sale. In my view, this is too weak a test.

CONCLUSION

An effective and complete way to prevent "trafficking" in tax losses is to limit a loss company, after a major change in its stock ownership, to carryovers equal to the purchase price paid by the buyer. The buyer should be allowed to use those carryovers, up to the ceiling, without further annual limitation. At most, the buyer's use of carryovers should be stretched out over no more than 5 years.

Cash and cash-equivalent assets owned by a loss company at the date of sale should reduce the allowed total amount of carryovers that survive the sale.

PROPOSED STATUTORY DRAFT OF PURCHASE PRICE RULE FOR LOSS AND CREDIT CARRYOVERS

SEC. 270. LIMITATION ON ALLOWANCE OF NET OPERATING LOSS, CAPITAL LOSS, AND CREDIT CARRYOVERS

(a) General Rule.—In the case of a change in control of a corporation, the amount of—

(1) Net operating loss carryovers;

(2 Net capital loss carryovers which can otherwise be carried forward under section 1212; and

(3 Credit carryovers which can otherwise be carried forward under Part IV of Subchapter A and under section 904(d)

of the corporation (referred to hereafter as the "loss corporation") from a pre-change taxable year to a post-change taxable year shall not exceed an amount equal to the acquisition value of the loss corporation. For purposes of the preceding sentence, the term "pre-change taxable year" means a taxable year of a loss corporation ending before the taxable year in which a change in control occurs. The term "post-change taxable year" means the taxable year of a loss corporation which includes a change in control, and subsequent taxable years.

(b) Change in Control Defined.—

(1) In General.—For purposes of this section, the term "change in control" means—

(A) a purchase of outstanding shares from one or more shareholders, a new issue of shares by the loss corporation in exchange for consideration (including an exchange to which section 351 applies and a recapitalization described in section 368(a)(1)(E)), or a redemption of outstanding stock of a loss corporation, as a result of which any one or more of the shareholders on the last day of the taxable year own a percentage of the total outstanding stock which is 50 percentage points or more in either total fair market value or voting power than the same percentage owned by the same persons at the beginning of that taxable year, or at the beginning of the first or second preceding taxable years; or

(B) a reorganization (within the meaning of section 368(a)(1) other than subparagraph (E) thereof) of a loss corporation, as a result of which the shareholders (immediately before the transaction) of the loss corporation own (immediately after the transaction) less than 50 percent of the total voting power or less than 50 percent of the fair market value of all outstanding stock of the acquiring corporation or of a corporation in control of the acquiring corporation; or

(C) any combination of the transactions described in subparagraphs (A) and (B).

For purposes of this subsection, the term "purchase" means an acquisition of stock the basis of which is determined by reference to its cost of the holder thereof.

(2) Exceptions.—Paragraph (1) shall not apply to changes in control resulting from—

(A) Acquisitions of stock by any person who owns, on the last day of the taxable year, less than 5 percent of the total fair market value of the outstanding stock of the corporation;

(B) Transfers of stock between persons who are each actual or constructive owners of such shares under the rules prescribed by paragraph (3) of subsection (e), or from transfers of stock in connection with a divorce, separation or similar marital event;

(C) Transfers of stock to the extent that the basis thereof is determined under section 1014 (relating to property acquired from a decedent) or section 1015 (a) or (b) (relating to property acquired by gift or transfer in trust), or from transfers of stock in satisfaction of a right to receive a pecuniary bequest;

(D) A redemption to pay death taxes to which section 303 applies;

(E) Acquisitions of stock or of an increased percentage interest by a trust which is exempt from tax under section 501(a), or by one or more persons who were full-time employees of the loss corporation continuously during the period of 60 months ending on the last day of the taxable year (or continuously during the period of the corporation's existence, if shorter);

(F) Acquisitions of stock by a creditor of the loss corporation in exchange for a creditor claim against the corporation, but only if the claim was not acquired for a purpose to obtain such stock, and only if the stock is received pursuant to a plan for rehabilitation of a financially troubled business in which holders of a majority of creditor claims by number and amount participate; or

(G) A reorganization which qualifies under section 368(a)(3)(D)(ii).

(c) Acquisition Value Defined.—For purposes of this section, the term "acquisition value" means the unadjusted acquisition value (as defined in paragraph (1)), computed with the modifications described in paragraph (2).

(1) Unadjusted Acquisition Value.—

(A) Purchases, Etc.; Gross Up.—In the case of a change in control resulting from a transaction referred to in subsection (b)(1)(A), or from any combination of such transactions during any period of 36 consecutive months, "unadjusted acquisition value" shall be determined as follows:

(i) The aggregate price paid by the person or persons who acquire stock of the loss corporation (plus the entire amount paid by the corporation for shares redeemed, if any) will be divided by the sum of the number of shares acquired plus the number of shares redeemed, if any;

(ii) The result in (i) will then be multiplied by the total number of shares actually outstanding after the transaction; and

(iii) From the figure reached under (i) and (ii) there will be deducted the sum of all money or property paid in to the loss corporation in exchange for treasury shares or newly issued shares.

(B) Reorganizations.—In the case of a reorganization referred to in subsection (b)(1)(B) in which stock is received or retained by shareholders of the loss corporation, "unadjusted acquisition value" will be deemed to be equal to the fair market value of such stock plus the amount of money and the fair market value of other property, if any, received by shareholders of the loss corporation.

(2) Modifications.—The unadjusted acquisition value determined under paragraph (1) shall be reduced by:

(A) Cash and cash equivalents.—The amount of cash (plus current receivables and minus current payables) owned by the loss corporation at the date of the change in control; and by

(B) Nonbusiness assets.—The fair market value of—

(i) assets of the kind which produce personal holding company income (as defined in section 543(a)), owned by the loss corporation on the date of the change in control, but without regard to whether or not the corporation is in fact a personal holding company as defined in section 542; and

(ii) business assets acquired within 24 months before the date of the change in control as a contribution to capital or in exchange for stock of the corporation.

Subparagraph (B) shall not apply to the extent the taxpayer establishes to the satisfaction of the Secretary that the property was acquired as an integral part of a bona fide plan to solve serious financial difficulties of the business.

(d) Disposition of Business Assets Following a Change in Control.—

(1) General Rule.—If, within 5 post-change taxable years, a loss corporation (or its successor in a reorganization or liquidation to which section 332 applies), sells or otherwise disposes of any business asset (other than inventory sold in the ordinary course of business) owned by the corporation at the date of the change in control, the entire amount realized will decrease unused acquisition value as of the first day of the taxable year. If such amount exceeds such unused acquisition value, the excess shall be ordinary income to the loss corporation or its successor to the extent of acquisition value absorbed in prior taxable years. Except for section 47 (dealing with recapture of investment credit), no other or additional gain or loss will be recognized to the loss corporation or its successor on a disposition to which this paragraph applies.

(2) Amount Realized.—For purposes of paragraph (1), the amount realized shall be:

(A) In the case of a sale or exchange, the amount of money plus the fair market value of other property received;

(B) In the case of any distribution to shareholders (including redemptions and distributions to which section 301 applies), the fair market value of the business assets distributed.

(3) Exceptions.—

(A) Reorganizations; Section 332.—If substantially all the assets of the loss corporation are transferred to another corporation in a reorganization described in section 368(a)(1) or in a liquidation to which section 332 applies, paragraph (1) shall not apply to the transfer, but will apply to later dispositions by the transferee.

(B) Other nonrecognition transactions.—Paragraph (1) shall not apply to a sale or other disposition in which gain or loss is not recognized in whole or in part.

(C) Purchase of assets in same business.—Paragraph (1) shall not apply if, within 6 months after the date of sale or other disposition, the corporation purchases, for an amount not less than the sale price, other assets for use in the same trade or business as that in which the assets sold or otherwise disposed of were used.

(e) Operating Rules.—

(1) Absorption of Carryovers.—In each post-change taxable year, net operating loss, capital loss, and credit carryovers from pre-change taxable years shall be absorbed to the extent there is sufficient unused acquisition value, in the sequence elected by the taxpayer or, in the absence of such an election, in the sequence and manner prescribed by regulations adopted by the Secretary. In applying the preceding sentence, capital loss carryovers to a post-change taxable year may offset capital gains in an amount not greater than ⅔ of unused acquisition value, and tax credit carryovers may be utilized in a post-change taxable year in an amount not greater than ½ the amount of unused acquisition value.

(2) Unused Acquisition Value.—The term "unused acquisition value" means the excess of acquisition value over—

(A) The amount of net operating loss carryovers to which subsection (a) applies and which has been deducted in prior post-change taxable years;

(B) ⅔ of the amount of capital loss carryovers to which subsection (a) applies and which were used to offset capital gains in prior post-change taxable years; and

(C) Two times the amount of any credit carryovers used in reduction of tax in prior post-change taxable years.

(3) Constructive Ownership.—For purposes of subsection (b), the rules applicable in determining ownership of stock under section 341(d)(1) (relating to collapsible corporations) shall apply in determining changes in control.

(4) Definition of Stock.—For purposes of subsection (b), the term "stock" does not include stock which is:

(A) Not entitled to vote,

(B) Fixed and preferred as to dividends and not entitled to participate in the distribution of earnings in excess of such dividends, and

(C) Not convertible into stock which fails to meet the requirement of (A) or (B).

(f) Special Rules.—For purposes of this section—

(1) Multiple Classes of Stock.—Where more than one class of stock is outstanding, acquisition value will be determined under regulations prescribed by the Secretary, taking into account the relative fair market value, the relative voting power and the relative degree of participation in earnings of each class of outstanding stock.

(2) Stock Acquired for Property; Contributions to Capital.—Where stock of a loss corporation is issued in exchange for property other than money, the price paid by the acquirer will be deemed equal to the fair market value of the property transferred to the corporation. Any transfer of money or other property to a loss corporation as a contribution to capital shall be treated as an exchange of such money or other property for stock of the corporation equal in value to the fair market value of the money or other property transferred.

(3) Series of Transactions.—If a change in control described in subsection (b)(1)(A) is followed, within the succeeding 36 months, by a reorganization to which subsection (b)(1)(B) applies, and to which the person or persons who obtained control are a party, this section shall not apply to the reorganization. If stock acquisitions not resulting in a change of control occur within 36 months before the date of a reorganization to which subsection (b)(1)(B) applies, acquisition value shall be determined by an average price per share under regulations which shall follow the method set forth in subsection (c)(1)(A). Where stock purchases or other stock acquisitions by an acquiring corporation precede, by more than 36 months, a reorganization to which subsection (b)(1)(B) applies, or where nonexchanging shareholders remain after a reorganization described in section 368(a)(1)(B), acquisition value shall be determined by grossing up the consideration issued in the reorganization, under regulations prescribed by the Secretary applying a method similar to the method set forth in subsection (c)(1)(A).

(4) Successive Transactions.—Notwithstanding the provisions of subection (c), if the limitation under subsection (a) has once been imposed on a carryover, and if another chance in control occurs at a later date, the acquisition value arising upon the later change in control shall not exceed the unused acquisition value as of the end of the taxable year immediately preceding the later change in control.

Chairman RANGEL. Could you provide staff some of the abuses that you see in the 1976 act, so that we can make certain in considering your new resolution to those problems that you attempted to identify all of them based on your past experience in patching up existing law, and your knowledge of what it was before you attempted to do that?

Mr. BACON. Yes.

Chairman RANGEL. Thank you very much.

[The information follows:]

The following material summarizes (1) major changes made by the 1976 act amendments to Code section 382, and (2) reasons for a different approach represented by the purchase price proposal.

A. MAJOR CHANGES TO CODE SECTION 382 MADE BY THE TAX REFORM ACT OF 1976

1. Section 382(a) of the original 1954 Code permits loss carryovers to survive in full so long as one or more purchasers of 50% or more of a loss corporation's stock continue for at least two years the same general type of business as that conducted by the loss company at the time of the change in ownership. The income tax regulations under this test often made it difficult for taxpayers to satisfy the business continuity test, especially where the historic business had been contracted or had become inactive as a result of financial difficulty. On the other hand, if the business continuity test were satisfied, the new owner could transfer in an entirely different business and use the loss carryovers against profits from the new business, even if

the old business produced no income at all. See Reg. § 1.382(a)-1(h)(8). The 1976 Act eliminated the business continuity test entirely, and substituted a test that scaled down the carryovers depending on the extent of continuity of stock ownership by former shareholders of the loss company.

2. The 1976 Act doubled the minimum continuity of stock ownership necessary for full survival of carryovers from 20% to 40%. (On the other hand, the 1976 Act eliminated the all-or-nothing feature of the business continuity test for purchases of stock, and substituted a gradual scaling down of carryovers depending on the extent to which the loss company's shareholders ended up owning less than 40% of the company after the change of ownership.)

3. The 1976 Act expanded the coverage of the loss carryover limitations to cover more technical ways that a 50% or greater change in stock ownership, directly or indirectly, could be achieved.

4. The 1976 Act expanded the time period which would be taken into account in determining whether a 50% or greater change in stock control of a loss company had occurred. The 1976 Act lengthened the "lookback period" from two years to three years. It also prevented short taxable years from artificially shortening the lookback period for this purpose. The new rules aimed at catching creeping acquisitions of control of the loss company.

5. The 1976 Act prevented certain kinds of preferred stock from being used to transfer stock control of a loss company while sidestepping any limitations on the company's loss carryovers. The original 1954 Code rules ignore nonvoting stock which is limited and preferred as to dividends. However, in one case, new investors in a loss company exploited this exception by buying a new class of nonvoting preferred stock which contained large redemption and liquidating preferences. These preferences were designed to siphon off to the new owners 90% of the profits to be earned from a new business after those profits had been sheltered by the company's loss carryovers. A court held that the limitations in section 382 did not reach this "enriched" stock. See *Maxwell Hardware Co.*, 343 F.2d 713 (9th Cir. 1965). The 1976 Act prevented this result from occurring againg by limiting the preferred stock exception to exclude stock which participates in corporate growth, or which has special redemption and liquidation rights, or which is convertible into another class of stock.

6. The 1976 Act applied the limitations or loss carryovers to carryover of a loss incurred in the change of ownership year itself. The original 1954 Code rules did not limit the carryover of such losses.

7. In the case of taxfree reorganizations, the 1976 Act brought stock-for-stock (type B) reorganizations under the limitations. Such reorganizations were not covered by the original 1954 Code.

8. If a loss company is acquired in a "triangular" reorganization, so that it ends up as a controlled subsidiary of an acquiring (parent) company, and the loss shareholders receive stock in the parent company, the original 1954 Code rule (sec. 382(b)(6)) required only that the value of the stock received by the old shareholders constitute at least 20% of the value of the subsidiary's stock. If the loss company's assets were acquired by a mere shell subsidiary, this rule resulted in the continuity of interest percentage always being satisfied. The 1976 Act changed this rule and measured continuity by the percentage of the stock value of the parent company given to the loss company's shareholders.

9. The 1976 Act also contained several liberalizing exceptions to relieve undue hardship caused by the original 1954 Code rules. Before 1976 one court had held that if a loss company's assets were acquired in a taxfree reorganization in return for stock which is retained by the loss company (rather than actually distributed to its shareholders), the loss carryovers disappear entirely. The 1976 Act overturned this court decision and "deemed" the loss shareholders as owning the undistributed stock in proportion to the value of their continuing stock interest in the former loss company. See *World Service Life Insurance Company*, 471 F.2d 247 (8th Cir. 1973). The 1976 Act also liberalized a common ownership exception under which NOL carryovers are not scaled down if the target and acquiring companies are owned substantially by the same persons in the same proportions. The Internal Revenue Service had held that constructive ownership rules did not apply under this exception. This meant that it was often difficult to combine subsidiaries within chains of controlled groups of corporations. The 1976 Act applied constructive ownership rules and thus made it easier to combine such subsidiaries within a larger group of companies.

B. REASONS FOR PURCHASE PRICE PROPOSAL RATHER THAN 1976 ACT APPROACH

1. The 1976 Act tied the survival of carryovers to the degree of continuing stock-ownership by shareholders of the loss company. This type of test (also currently used in section 382(b) ignores the separateness of the corporation as a taxable entity. It also requires a point to be fixed where the scaling down of losses begins. That point in turn requires a policy judgment about the relative size of the companies that should be permitted to combine with full survival, or less survival, of attributes. By requiring 40% continuity by the loss shareholders, the 1976 Act rule means, in effect, that carryovers survive in full only if the acquiring company is no more than one and a half times larger than the loss company. Those judgments do not seem properly made by tax people, and belong more to antitrust policy than tax policy.

a. Keying the amount of carryovers solely to the degree of change in ownership is also flawed if a uniform scaledown applies, as under the 1976 version of section 382, to stock purchases and reorganizations. If the shareholders' interests are viewed as indirect ownership of the assets inside the corporate shell, a purchase of outstanding stock divides the loss company's capital, whereas a merger with a profit company creates an expanded pool of capital. There is no equivalence between these two cases that justifies the same scaledown based solely on a uniform percentage of shareholder continuity. A 10 percent continuing interest by the loss company's owners in their own company after a sale of 90 percent of the outstanding stock of the company to an outsider is worth less than a 10 percent continuing interest by these owners after a merger of their company with another company.

Example.—Loss company L, having $1 million net worth, merges with profit company P, having $9 million net worth, in exchange for 10 percent of the common stock of surviving company, LP. L had a loss carryover of $10 million. Under present law, the carryover would be reduced to $5 million. If the same percentage scaledown were applied to a taxable sale of a loss company's stock, and the shareholders of L sold 90 percent of their stock to a new investor for cash, L's carryover would also be reduced to $5 million. But these two transactions are not the same economically. After the merger, L's shareholders continue to own the same value they owned before ($1 million), while after a taxable sale of 90 percent of their stock for cash, the value of their interest in the loss company is reduced to $100,000. The dollar amount of L's carryover should not be reduced by the same amount in both cases.

b. The old shareholders' continuing indirect interest in their company's assets after a merger is also not accurately reflected by a scaledown according to the shareholders' percentage interest in the combined enterprise.

2. A shareholder continuity test did not prevent the buyer of a loss company from obtaining tax benefits from NOL carryovers greater than his economic cost incurred in obtaining the tax benefits. (This is the classic abuse considered "trafficking" in loss carryovers). Under a shareholder continuity test, too much, or in some cases too few, carryovers could result for the new owner.

3. Further study of the loss carryover area since 1976 has led to a consensus among many practitioners that, if limitations are to be continued on loss carryovers, a more rational approach would be to relate the amount of surviving carryovers to the amount of income which the loss company's assets were likely to have earned if the company's ownership had not changed. Such a test would more likely achieve a "neutral" rule, so that tax benefits from carryovers would neither encourage or discourage an acquisition of a loss company. Such a test would not depend on any arbitrary percentage of continuing stock ownership by former owners of the loss company, per the original 1954 Code and the 1976 Act.

(Note, however, that a somewhat arbitrary shareholder continuity test is still used as the threshold trigger for a purchase price limitation. That is, all the current variations of a purchase price rule trigger limitations by a 50 percent or greater change in stock control of a loss company. This trigger could be set at a lower level, especially since "effective" control of a corporation may be exercised by a person or group owning less than 50 percent of the total outstanding stock.)

5. The 1976 act did not deal satisfactorily with the role that Section 269 would play in connection with Section 382. It was left unclear whether IRS could still disallow some or all of the carryovers which satisfied the tests of Section 382, but where IRS still could show that obtaining tax benefits from carryovers was the principal purpose of the acquisition. It was unclear, for example, if IRS could still invoke Section 269 where, immediately after buying a loss company, the new owner caused the loss company to sell off most (or all) of the business assets it owned before the merger.

6. The 1976 act also did not deal with the continuing need, if any, for loss carryover limitations prescribed by the consolidated return regulations, especially the so-called separate return limitation year ("SRLY") rule and the consolidated return change of ownership ("CRCO") limitation.

7. The 1976 act also did not cover built-in losses. It did not necessarily express a policy that such losses should, or should not, be limited after a change of control of a loss company. This question was simply left open. Many practitioners feel that the statute should take a position one way or the other on the tax treatment of built-in losses (and built-in gains) after a corporate acquisition.

STATEMENT OF NICHOLAS TOMASULO, ESQ., SILVERSTEIN & MULLENS, WASHINGTON, DC

Mr. TOMASULO. Since my subject is closely tied to Mr. Bacon's, we thought not to interrupt the continuity of thought so we would follow each other.

Chairman RANGEL. Without objection.

Mr. TOMASULO. Thank you very much.

My name is Nicholas Tomasulo. I want to say I have thought about this subject at least since 1958, and have been a legislative man a long time. In 1958, I was liaison with the advisers group—mentioned by Dick Bacon—who worked on this problem. After much study, they came up with a conclusion that the losses should be limited to some function of the purchase price.

But more than that, they defined the problem in basic terms, and we can restate that now. The basic problem is differentiating between the acquisition of a corporation which actually has a business, in other words, the person buying the corporation wants to buy this corporation because it has got a hardware store in it, or whatever business it is, and the case of a person buying a corporation which has nothing in it but United States Steel stock, because he wants the tax losses of the corporation.

Now, that is the basic question we are facing here. Naturally, to give this a nice name, to say you can buy losses attached only to investments or to cash, we have created the neutrality principle, which you might call the son of safe harbor leasing, because it does exactly the same thing. It says an investment is a business, whereas everybody can see an investment is not a business.

The distinction between the passive assets, the treatment of passive assets and cash equivalents is the key question presented here, and determines whether we are going to have a good statute, which limits manipulation, rather than a return to the formality of the pre-1954 code law.

The neutrality principle was not invented now, but was discovered in 1948 by Judge Arundell in the *Alprosa Watch Corp.* case, when he said that it did not make any difference that none of the businesses were the same, it did not make any difference that none of the stockholders were the same, as long as you had the same charter, you had the losses.

Now, we do not want a return to that, and if we do return to that, that is so much worse than present law, that it is much better to stand where we are and to enact no new statute.

I call these losses, to identify them, Zombie losses, because they are really quite similar to the West Indian voodoo spirits. In West Indian voodoo they say that when a person dies a Zombie, who is

another spirit, with no connection, no real connection with the dead man, walks in and uses his body.

In the same way, what happens here is that a second taxpayer walks in and uses the body, that is, the charter of the old taxpayer, but it is not the same taxpayer. A St. Bernard can see it is not the same taxpayer, and the neutrality principle does not make it the same taxpayer in any behavioral, or commonsense meaning.

I think I will pause there, but I would like to come back and talk with you further.

[The prepared statement follows:]

STATEMENT OF NICHOLAS TOMASULO, SILVERSTEIN & MULLENS, WASHINGTON, DC

TOPICAL OUTLINE

Before the 1954 Code the law was, in general, very formalistic and losses could be transferred if the charter was preserved without regard to other circumstances. Thus, the losses of a "Zombie corporation," that is, one which had sold all its business assets, nevertheless survived a sale of all the stock (Alprosa Watch).

If the 1954 Code provisions are now eliminated and no new ones substituted, we will return to the old formalism and create licenses to buy and sell fictitious losses.

However, it is now apparent that, for operating loss purposes, when all the stock is sold, the character, identity and size of the corporation must be determined solely by the kind and amount of business assets it is engaged in exploiting and not at all by the amount of investments it owns. For this reason, the amount of investments owned by a loss corporation at the time its stock is sold must be disregarded in determining the amount of losses which will be permitted to survive.

STATEMENT

My name is Nicholas Tomasulo, of Silverstein and Mullens, 1776 K Street, N.W., Washington, D.C. 20006, 202-452-7952.

I am appearing solely on my own behalf and not as representing my firm or any client or organization.

1. First, I want to compliment the Committee on asking for a review of the whole field. Of course, this is the way the subject should be considered.

2. To understand the 1954 Code provisions we must go back just enough to see what the law was before the Enactment of that Code.

3. Before the 1954 Code, the law was formalistic to the nth degree. The losses did not survive a reorganization if the old charter was not used, even when it was quite clear that the corporation was the same taxpayer after the transaction as it was before. (*New Colonial Ice Co., Inc.* v. *Helvering*, 292 U.S. 454 [1934].) On the other hand, the corporate losses did survive a sale of all the stock as long as the charter remained the same even though the post-sale corporation was not the same taxpayer as the pre-sale corporation in any rational sense because: (a) the post-sale corporation had none of the shareholders of the pre-sale corporation; (b) the post-sale corporation had none of the businesses or business assets of the pre-sale corporation; (c) the only connection between the two distinct taxpayers was that they both used the same charter (although at different times). (*Alprosa Watch Corporation* v. *Commissioner*, 11 T.C. 240 [1948].)

4. Before the 1954 Code, the *Alprosa Watch* case was considered the horror case, the loophole, and the golden opportunity to buy and sell losses made of pure hot air. These losses were sometimes called "Alprosa losses" or "Charter losses." I like to call them "Zombie losses," because they are, in effect, the losses of businesses which had died at the time of the stock transfer. Similarly, I call the corporation a "Zombie corporation." [The last three paragraphs of the *Alprosa Watch* decision are quoted in full in an appendix at the end of this paper.]

5. The enactment of the new Code in 1954 more or less put an end to the extreme formalism of New Colonial Ice and Alprosa Watch. Whether or not the old charter survived became relatively insignificant and more rational tests were enacted into law. Under section 382(b) (as enacted in 1954), in the case of a reorganization, if the stock in the survivor corporation received by the shareholders of the loss corporation is short of 20 percent of the stock of the survivor, the operating losses are cut down by five times the amount of the shortage. Under section 269 (originally section 129 of the 1939 Code), any deduction credit or allowance resulting from the acquisi-

tion of a corporation (in any manner) may be disallowed, in whole or in part, if the acquisition was made with the principal purpose of the avoidance of Federal Income Tax. Finally, under section 382(a), as enacted in 1954, if more than 50 percent of the stock of a corporation changes hands within a one year or two year period, then, if the corporation does not continue to carry on a trade or business substantially the same as that carried on before the stock changed hands, the net operating losses are not allowed.

6. (a) A "Zombie corporation" is a corporation all of the business assets of which are disposed of either before or after the transfer of stock. (Alprosa Watch.) Of course, if some, but not all, of the business assets are disposed of either before or after the stock transfer, the corporation is only a Zombie corporation pro tanto. A corporation which owns investments rather than business assets is a Zombie corporation to the extent of such investments.

(b) Under present 1954 Code provisions (disregarding the suspended 1976 amendments), the losses of a 100 percent Zombie corporation cannot be freely bought and sold. In Rev. Rul. 67-186, 1967-2 C.B. 81, it was held that on the purchase of a 100 percent Zombie corporation (which owned only portfolio securities) none of the losses produced by former discontinued businesses would be allowed under section 382(a). In any case in which section 382(a) did not apply, such as for example a reorganization, it would seem that the principles of *Commissioner* v. *British Motor Car Distributors Ltd.* (278 Federal 392, C.A. 9, 1960) would operate to eliminate the losses. That decision, under section 129 of the 1939 Code involved the unsuccessful attempted use of losses incurred in selling home appliances against the income of an automobile business placed in the corporation after the stock transfer by the new owners.

7. Since it seems quite clear that, under present law, there can be no transfer of the losses of a 100 percent Zombie corporation (which, for example, owns only Portfolio Securities) it is hard to believe that anyone would urge that we return to the rule of the formal, moldy and nonsensical *Alprosa Watch* case, and permit the transfer of losses of a corporation that has become a pure investment company. However, up to this point this is exactly what the American Bar has been doing, taking the position that if the corporation owns a $1,000,000 Deposit Certificate it should be treated in the same manner as if it owned $1,000,000 in factory machinery. I must say I am not ingenuous enough to believe this position is sincere. I think quite simply that it (the Bar) is just trying to put itself in what it conceives (mistakenly) to be a strong bargaining position.

8. Despite the position of the Bar (and perhaps some other groups), it now seems quite clear that both here in Congress and in the Treasury there is no desire to enact a statute or amendment bringing back Alprosa Watch in the case of a 100 percent owned Zombie corporation. As an old-time legislative man, it means quite clear to me that the public perception of such a statute would be even worse than the public perception of the "safe harbor" leasing provisions.

9. What should we do in the case of a corporation that has some business assets and some investments divided in percentages, say (25-75), (50-50), (15-85)? In such a case, the equitable and fair thing to do is to treat the corporation as if it had only the business assets, so that the presence of the investments is completely neutral and neither increases nor decreases the amount of losses which would be allowable if the investments were not present. This can be done very easily by simply subtracting the investments from the purchase price of the stock as otherwise determined.

The suggestion, for example, that a corporation which has one-third business assets be treated as if it had three-thirds business assets makes no sense. Under this approach, a corporation with $1,000,000 in business assets will be treated the same as one with $3,000,000 in business assets. Obviously, this is grossly unfair to one corporation or the other or to both.

10. (a) I must stress once more the fact that the public perception of allowing losses with respect to cash or investments in a corporation will be most unfavorable. Obviously, a tin can full of quarters does not look like a "taxpayer" to most persons.

(b) If proper adjustment is made for investments, then losses should be usable at once and a stretch-out of the time is unfair and not needed.

(c) The statute should not apply to a thrift institution, continued as such, or merged into another thrift institution. It also should not apply to a bank, continued as such or merged into another bank.

11. An article by Mr. Bacon and myself suggesting a proposed net operating loss statute was published in Tax Notes for Monday, Sept. 12, 1983, Volume XX, Number 11, pages 835 to 852. I have a copy here and respectfully ask that it be printed in the record.

12. Thank you very much. I will be very pleased to answer any questions.

APPENDIX A

Alprosa Watch Corporation, Petitioner, v. *Commissioner of Internal Revenue, Respondent.* Docket 12368, Aug. 31, 1948. 11 Tax Court 240 at bottom page 245.

The remaining question in the case is whether Esspi and petitioner are actually the same corporate entity. In view of the established principle that a corporation and its stockholders are separate legal entities, it is recognized that a change in stock ownership does not produce a new corporate personality. *Erie Coca-Cola Bottling Co.,* 1 B.T.A. 531; *East Coast Motors, Inc.,* 35 B.T.A. 212. In *Northway Securities Co.,* 23 B.T.A. 532, we held that the petitioner corporation was the same jural person as its so-called predecessor, notwithstanding a change in name, business situs, and type of business. Cf. *American Coast Line, Inc.* v. *Commissioner,* 159 Fed. (2d) 665.

In the case before us the corporate name was changed, the locus of business was immediately moved, the corporate stock was acquired by new owners, and the nature of the business was converted from the manufacture and sale of gloves to the purchase and sale of jewelry. The new business activity was authorized by the original certificate of incorporation. Furthermore, it is significant that no steps were taken to liquidate Esspi in the taxable year—in fact, petitioner conducted business for three years thereafter. In these circumstances, and on the authority of the cited cases, we hold that Esspi Glove Corporation and Alprosa Watch Corporation were the same corporate person for Federal tax purposes.

As it is our conclusion that the petitioner and Esspi Glove Corporation constitute for Federal tax purposes one and the same taxpayer, it follows that petitioner may include in its corporate tax returns for the fiscal year ended June 30, 1943, the income and expenses of the Esspi Corporation for the period July 1, 1942, to June 14, 1943, and is entitled to deduct the net operating losses of the latter company for its prior taxable year ended april 30, 1942. We hold further that petitioner is entitled to the use of the unused excess profits credits of the Esspi Glove Corporation in computing its excess profits credit for the taxable year ended June 30, 1943.

Decision will be entered under Rule 50.

NET OPERATING LOSS AND CREDIT CARRYOVERS: THE SEARCH FOR CORPORATE IDENTITY

by Richard L. Bacon and Nicholas A. Tomasulo

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In this article, Bacon and Tomasulo define the concept of "trafficking" in loss carryovers as the obtaining of carryovers disconnected from business assets. They criticize current law's attempts to deal with this problem and propose a new rule that would allow an acquirer to use no more carryovers than the loss company itself could have expected to use if its assets or stock had not been sold.

The authors analyze an American Law Institute proposal to allow carryovers against a percentage of the surviving company's income or against a presumed rate of return on the purchase price of a loss company's stock. They recommend an alternative that would allow carryovers in all cases equal to the purchase price itself. This alternative, they argue, better carries out the objectives of the ALI proposal and is simpler to understand, draft, and apply.

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I. INTRODUCTION

The tax law generally allows corporations and other business taxpayers to use net operating losses, capital losses, and unused tax credits that arise in one year as offsets to income in earlier and later years. Carryovers also cross the lines of corporate fusion in a merger or other acquisition,[1] but sections 382 and 383 expressly limit the survival of operating loss carryovers, capital loss carryovers, and credit carryovers after taxable sales and purchases of stock, redemptions, and reorganizations. The aim is to prevent "trafficking" in losses.

A revision of the carryover restrictions enacted in 1976 has been postponed three times and is currently scheduled to take effect on January 1, 1984. Congress has heard much criticism of the theory behind the 1976 version, and calls to replace it with something else, but no consensus has emerged during the last seven years. The loss carryover issue has a long history, of course, and is still "the most hotly debated of the sore spots in the revenue laws."[2] The arena for debate covers major changes in the life of a corporation such as a reorganization, a purchase of some or all of its outstanding stock, bankruptcy, major changes in the shareholders, or a shrinking or changing of the company's business.

[1]Carryovers of losses and credits following a tax-free reorganization are generally permitted under Code section 381. The term "loss company" in this article refers to a corporation which, as of the date of a reorganization or other change in control, has unused loss or credit carryovers from one or more earlier taxable years.

[2]Testimony of C. Rudolf Peterson, in Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, House Ways and Means Committee, 86th Cong. 1st Sess. 418 (Feb. 26, 1959).

Senator Dole's recent call for the congressional tax staffs to review subchapter C has spurred new study of the loss carryover issue,[3] and initial corporate proposals by the Senate Finance Committee staff have already appeared.[4] The time is thus ripe to review the legislative treatment of net operating loss carryovers, and other carryovers, after a corporate merger or change in control of a loss company.

...If stock control of a loss company changes hands, the company's net operating loss, capital loss, and tax credit carryovers should survive in an amount equal to the value of the loss company at the date of the acquisition.

At bottom, the loss carryover debate goes to the heart of corporate identity. Why should a corporation be allowed to average good and bad years? To what extent should a corporation be treated as an entity different from a partnership and taxable apart from its shareholders? Should shareholders be viewed as suffering the detriment and receiving the benefit of corporate losses which carry back or forward to offset income in other years? To what extent is "a corporation" the same or different if its shareholders or its business, or both, change? Even where Congress uses the federal income tax law to carry out economic and social policy, an underlying decision is being made as to the degree to which a corporation is itself a source of jobs or economic effects, desirable or undesirable, depending on the company's behavior in the marketplace. The rise and fall of safe harbor leasing during 1981-82 illustrates the length to which the tax system sometimes goes in experimenting with incentives for corporate taxpayers to buy certain kinds of property or to locate in certain places (such as enterprise zones), or to create more equal business opportunities (the level playing field concept) in order to help the national or regional economy. Safe harbor leasing also sought to put cash in the hands of businesses needing some type of financial assistance.[5]

A. Effects of ERTA and TEFRA

The debate over loss and credit carryovers has taken new twists by the fallout from the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). In light of the accelerated deductions allowed in 1981 for depreciation (ACRS), a net operating loss no longer necessarily denotes a company in financial trouble. The investment credit and ACRS deductions were often so large that they exceeded the capacity of some companies, even those not in financial trouble, to absorb them fully—a condition giving rise to "artificial" losses and credit carryovers which reflected timing factors. Through safe harbor leasing, ERTA permitted businesses finding themselves in this position to sell future tax credits and ACRS deductions while retaining actual use of the property. This explicit selling and buying of tax-reducing attributes disconnected from any productive use of the property by the buyer produced large and much publicized tax reductions for numerous big corporations. Perhaps because of the very openness of the approved "traffic" in tax benefits, safe harbor leasing was ridiculed and then repealed in TEFRA.[6] It may be too much to expect that Congress will not continue to use the federal tax system to deliver incentives to particular groups or to discourage behavior or investments by others.[7]

TEFRA did not radically change the accelerated deductions available through ACRS itself, however. For businesses which continue to incur artificial operating losses and tax credit carryovers, particularly in light of ERTA's generosity in lengthening the loss carryover period to 15 years,[8] the Treasury has expressed concern over a possible increase in "tax motivated mergers" in lieu of safe harbor leasing in order for acquirers to benefit from the artificial "losses" which other companies can no longer sell openly.[9]

For some businesses, of course, operating losses are all too real, caused by decreases in earnings. Real economic losses have plagued many businesses in capital-intensive and other industries because of the general recession, shifts in the country's industrial base, high interest rates, the presence (or absence) of regulation in specific industries, and other factors in a changing economy. These factors have pushed the number of business bankruptcies to near all time highs in many industries, including oil and gas, air transportation, steel, farm equipment, and financial services, including banks and savings and loan associations.

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[3]Senate Finance Committee Press Release No. 82-171, October 28, 1982.

[4]See "Finance Staff Makes Recommendations on Subchapter C," *Tax Notes*, August 15, 1983, p. 599. These proposals cover corporate tax rules other than carryovers.

[5]Congress has sometimes used the tax rules on loss carryovers and carrybacks to grant relief to specific companies. In 1967, Congress allowed American Motors Corporation to carry its 1967 and 1968 net operating losses back five years and forward three years. Former section 172(b)(1)(E). Section 374(e) allows participants in the Conrail reorganization of 1976 to "freeze" their net operating loss carryovers and revive them as and when they receive income from court awards or other valuation disputes.

[6]See Lubick and Galper, "The Defects of Safe Harbor Leasing and What to Do About Them," *Tax Notes*, March 15, 1982, p. 643; Ferguson, "Profiting from Tax Losses," 60 Taxes 1010 (1982). Some residues remain in the form of leasing by tax-exempt entities.

[7]See, for example, H.R. 3434, introduced on June 28, 1983, by Reps. Jones and Conable. This bill aims to aid smokestack industries by allowing companies to borrow in cash from the U.S. Treasury up to 85 percent of their unused investment credits. This plan is another way to give money-losing industries the full benefit of tax incentives to invest in new plant and equipment. Cong. Rec., June 27, 1983, p. H-4494. See "Son of Safe Harbor Leasing," *Fortune* Magazine, June 13, 1983, p. 29; Lippman, "Tax Credit Legislation Introduced: Bill Would Give Cash From Treasury to Corporations," *Washington Post*, July 5, 1983, p. D-7, col. 1.

[8]Section 172(b)(1)(B).

[9]See Chapoton, "A Clarification of the New Rules for Tax Leasing," *Wall Street Journal*, Dec. 8, 1981; Moore, "Repeal of Safe-Harbor Leasing May Stimulate Merger Activity," *Legal Times*, Sept. 20, 1982, p. 1; but cf. McDaniel and Surrey, "Tax Expenditures: How to Identify Them; How to Control Them," *Tax Notes*, May 24, 1982, pp. 595, 624.

The potential for tax-motivated mergers involving real troubled companies, and others suffering artificial tax losses, along with Congress's probable unwillingness to bail out more specific companies directly, intensifies the concern over transactions which may be structured by resourceful tax practitioners to join loss and credit carryovers of one corporation with taxable profits of another.[10]

B. Summary of the Proposal

In our view, "trafficking" involves buying tax losses and credits without being primarily interested in acquiring the business of the loss company. An effective rule to prevent this practice (at least in corporate acquisitions) should be relatively simple to understand, draft and apply in practice. It should also be neutral among different types of acquisitions; neutral in neither inducing nor inhibiting an acquisition; and effective in preventing acquisitions solely or primarily for tax attributes. Under these guidelines, and based on prior proposals by groups of scholars and practitioners in the American Law Institute (1982) and in the Advisory Group on Subchapter C (1958), we suggest that if stock control of a loss company changes hands, the company's net operating loss, capital loss, and tax credit carryovers should survive in an amount equal to the value of the loss company at the date of the acquisition. This value will be evidenced by the purchase price paid for its assets or stock, and if less than all the stock is purchased, the company's value will be grossed up from the amount paid for part of its stock. This rule would apply uniformly to taxable sales of stock, infusions of new money into a loss company, and reorganizations. The basic aim would be to allow new owners to use no more of the unused losses and credits than the loss company itself could have reasonably expected to use if the sale had not taken place. This rule, we believe, will make carryovers a neutral factor in acquisitions and block trafficking in tax attributes for their own sake, but will allow a flow of incidental tax items in normal business transactions. The version of this idea we propose will, in contrast to the rule proposed by the American Law Institute, allow practitioners to understand and apply a relatively simple rule.

Proposed statutory language and a technical explanation accompany this article.

II. THE UNDERPINNINGS OF PRESENT LAW

Our tax system decided some time ago to limit the occasional unjust effects of an inflexible annual accounting period by permitting a rough averaging of loss years and profitable years through the use of a net operating loss carryback and carryover from a loss year to a profitable year. Once this benefit is allowed to "taxpayers," however, it becomes essential to allow the deduction only to the same taxpayer who incurred the loss. In the case of individual proprietors, we have not (up to now) had much trouble applying this principle. Corporations present a more sophisticated question.

The structure of the corporate income tax—a tax on the corporate *owner* of income—is such that we cannot escape the conclusion that a corporation in year six is not the "same" as that corporation in year one if, during the five-year interval, there has occurred both a complete change in stock ownership within a relatively short period of time *and* a total change in the business conducted. A corporation engaged in manufacturing widgets, for example, as to which there is a complete (or major) change in stock ownership, remains the same "person" in reality only to the extent that it retains and continues to use widget-producing business assets. The reverse must also be true: the corporation *is* the "same" person as in prior years if (1) its shareholders have not entirely changed, or (2) the business has not changed, or (3) neither the business nor the shareholders have changed in major ways.

. . .sections 382 and 383 expressly limit the survival of operating loss carryovers, capital loss carryovers, and credit carryovers after taxable sales and purchases of stock, redemptions, and reorganizations.

The above principle has emerged from a long history. In 1934, the Supreme Court solemnly decided that insofar as the significance of the corporate entity in relation to carryovers is concerned, the world was flat as a pancake. In *New Colonial Ice Co. Inc. v. Helvering*,[11] "New Colonial Ice" was a New York State corporation formed to take over the business and assets of "Colonial Ice" (also a New York corporation). The new corporation continued the same business (manufacture of ice) with the same assets and had the same shareholders and creditors as the old. Nevertheless, the court held that New Colonial Ice was a different "taxpayer" because, and seemingly only because, it had a new charter. Accordingly, a loss carryover from the old corporation was denied. While this flat and formal world was a disaster for New Colonial Ice, it turned out to be a rich bonanza in *Alprosa Watch Corp. v. Commissioner*.[12] In that case, a loss carryover was allowed although (1) all the stock of a loss company was sold, (2) all of its business assets were disposed of shortly after the sale, (3) the old business was completely changed from manufacture of women's gloves to the sale of jewelry and watches, (4) the location of the business was moved, and (5) the corporate name was changed. The basis of the decision was that the watch corporation was the "same" corporate person as the glove corporation because (and only because) it continued to hold the same charter.

[10]See Ferguson, footnote 6, *supra*. An additional concern over carryovers stems from enactment of section 338 by TEFRA. Section 338 permits a corporate buyer of 80 percent or more of the stock of a target company to elect a cost basis for the target's assets. May a buyer of stock of a loss company not elect under section 338, promptly liquidate the target company, and claim carryovers via the general rule of section 381? The potential for such easy access to carryovers has already provoked comment. See "Loss carryforwards may be targets for takeovers under the 1982 tax act," Tax Report, *Wall Street Journal*, October 6, 1982, p. 1; Note, "TEFRA opens up loss corporation acquisition benefits," Shop Talk, 58 J. Taxation 399 (1982).

[11]292 U.S. 454 (1934), affirming 24 B.T.A. 886 (1931).

[12]11 T.C. 240 (1948).

A. The 1954 Code

Congress decided not to continue living in this formalistic world. Beginning with the 1954 Code, Congress attempted to make the loss carryover world "round" by allowing tax attributes generally to survive a reorganization (section 381) or a taxable sale of stock, subject to limitations of sections 382, 383, and 269.[13]

In light of...ACRS, a net operating loss no longer necessarily denotes a company in financial trouble.

The "purchase" rule of section 382(a) applies if, within a two-year period, 10 or fewer persons purchase more than 50 percent of the outstanding stock of a loss corporation. The loss carryovers are completely eliminated in that case if the corporation does not continue to carry on a trade or business substantially the same as it conducted before the purchase. The reorganization rule of section 382(b) does not take continuity of business into account but looks only to the degree of continuity of stock ownership. The rule provides that whenever a loss corporation is merged with another corporation, the carryovers survive if the former shareholders of the loss company own 20 percent of more of the fair market value of the stock of the combined enterprise; below that minimum level, the carryovers are scaled down by five percent for each percentage point less than 20 owned by the loss company's former owners.[14]

In 1976, Congress revised section 382 (which, as noted, has not gone into effect) to adopt a uniform stock ownership test for purchases of stock and reorganizations. A business continuity test was eliminated. The all-or-nothing rule for stock purchases was also eliminated, and a graduated reduction in the amount of carryovers, beginning if old shareholder continuity is less than 40 percent, was applied to changes in stock ownership by purchase as well as by reorganization.

B. Reasons for Limiting Loss and Credit Carryovers

It is commonly said that loss and credit carryovers must be limited after an acquisition to prevent "trafficking" in tax benefits. Oddly, there is little agreement on precisely what this term means. One notion of a visible evil is the advertised sale and purchase of net operating loss carryovers for considerably less than their full potential tax savings—the proverbial 10 cents on the dollar.[15] This type of "trafficking" occurs most egregiously through sales of shell corporations which contain few, if any, income-producing assets. One school of thought holds that trafficking does not occur even if tax attributes are transferred as disembodied assets apart from income-producing assets of the loss company, *provided* the sellers of the loss are fully compensated by receiving as close to the maximum 46 percent tax saving as possible. It does not follow, though, that trafficking does not occur so long as the sellers receive close to 46 percent for the tax benefits. A different school of thought insists that trafficking occurs if tax attributes are not an incidental part of a larger "package" consisting primarily of assets of an ongoing business, along with tax benefits. Those to whom this concept appeals would not bar sale of a carryover to new investors for a price, or use of the carryover against profits from a different business from that which generated the loss, so long as the tax benefits are related in a reasonable way to the total group of business assets transferred.

...'trafficking' involves buying tax losses and credits without being primarily interested in acquiring the business of the loss company.

For others, trafficking denotes any use of carryovers by a corporation owned by substantially different persons from those who were shareholders when a given year's loss or credit was incurred. This approach looks through the corporate shell and sees its owners as being "the true sufferers of the loss."[16] No trafficking occurs, in this view, if the owners of a money-losing business abandon their existing business and begin a completely different enterprise which produces profits; the same owners ought to be able to offset new business earnings with losses from the discontinued business. However, if a majority of the beneficial owners change, "their" loss should not be available to another group of owners. An extreme expression of this view might be that any purchase of 50 percent or more of a loss company's stock would be deemed, for tax purposes, to be a sale and purchase of

[13]It has been argued that the averaging rationale does not extend to corporations because corporations pass on their tax burdens to customers, employees, and shareholders, and since these persons change daily, the ultimate payors when the loss was incurred are not the same as the ultimate payors in the carryover year. Fleming, "Reflections on Section 382: Searching for a Rationale," 1979 Brigham Young Univ. L. Rev. 213, 218 (1979). Allowance of carrybacks and carryovers to corporations has been justified on averaging-related grounds: encouraging new enterprises and other types of risk or venture capital; equalizing competition for investment funds between businesses with wide cyclical swings and businesses with stable income; and stimulating investment in periods of recession or financial difficulty. H. Rept. 855, 76th Cong. 1st Sess. (Revenue Act of 1939), 1939-2 C.B. 504, 510-511 (1939); Statement of Richard A. Freling, in Public Hearings on Tax Reform before the House Ways and Means Committee, Part 5, p. 3626 (July 30, 1975).

[14]Section 383 requires the Treasury to prescribe similar rules for carryovers of capital losses and various tax credits, including the investment tax credit, the foreign tax credit and others. Code section 269 also permits the Secretary to broadly override these statutory rules and disallow loss and credit carryovers (and other tax benefits) if tax avoidance is the principal purpose of an acquisition of assets or stock control of a loss company.

[15]Instead of paying the full 46 percent tax saving to be obtained from the carryover, the buyer pays only 10 percent or less and thereby reaps a "windfall" of 36 percent of the dollar amount of the carryover.

[16]See, *e.g.* Asimow, "Detriment and Benefit of Net Operating Losses: A Unifying Theory," 24 Tax L. Rev. 1, 4 (1968).

assets, with complete disappearance of loss carryovers and other tax attributes of the selling company.[17]

Still others see loss and credit carryovers as inseparably part of the loss company's business and would allow carryovers to survive even a complete change in stock ownership, but only if the company, in the hands of new owners, continues to conduct the identical business which produced the loss. The case of *Libson Shops, Inc. v. Koehler*[18] is usually associated with the idea that trafficking occurs if the carryovers are offset against a different business from the particular activity (not just a similar activity) which produced the loss.

C. Different Remedies

The major alternatives which have been offered to deal with the trafficking problem are discussed below.

1. Existing Law. Existing law does not reflect any clear concept of the evil to be prevented. The tax rules are different depending on the form which an acquisition takes. If a new investor buys over half the stock of a loss company for cash or notes, as explained earlier, the carryovers survive so long as the existing business is continued for at least two taxable years.[19] Otherwise they disappear entirely. The new owner who continues the old business may, however, contribute an additional business or start a new business within the company and preserve the carryovers against those profits, provided the old business (and not necessarily the one which produced the loss) is also continued at least two years.[20] This is an all or nothing rule. On the other hand, if stock or assets are acquired by another corporation in a statutory merger or other tax-free reorganization, the carryovers depend on whether the former owners of the loss company receive 20 percent or less of the total stock of the acquiring company. The carryovers are scaled down (rather than instantly eliminated) if stock continuity is less than 20 percent. No clear policy explains why, under this rule, carryovers ought to fully survive if the profit company is no bigger than four times the size of the loss company, but not if the size difference is greater. Major loopholes also exist in both sets of rules.[21]

2. Business Continuity. An ordinary sale and purchase of assets for cash does not bring loss or credit carryovers to the buyer, even if the buyer continues the business in which the assets are used. It is also well settled that the owners of a money-losing business can abandon that business and switch to a completely different business and still carry over losses from their old business against profits from the new business. Plainly, for advocates of a business continuity test, more than merely continuing a business must be required. For those who like *Libson Shops*, a change in stock ownership seems equally necessary along with a change in business. In addition, a business continuity test creates difficult factual and definitional problems and also an uneconomic stress on continuing an activity that, in many cases and apart from taxes, ought to be ended.[22]

3. Changes in Stock Ownership. Those who believe that shareholders ultimately "suffer" the corporation's losses or excess credits would tie the dollar amount of an allowable carryover to the degree of change in stock ownership of the loss company. This type of test (currently used in section 382(b)) ignores the separateness of the corporation as a taxable entity. It also requires a point to be fixed where the scaling down of losses begins. That point in turn requires a policy judgment about the relative size of the companies that should be permitted to combine with full survival, or less survival, of attributes. Those judgments do not seem properly made by tax people, and belong more to antitrust policy than tax policy.

It is commonly said that loss and credit carryovers must be limited after an acquisition to prevent 'trafficking' in tax benefits. Oddly there is little agreement on precisely what this term means.

Keying the amount of carryovers solely to the degree of change in ownership is also flawed if a uniform scaledown applies, as under the 1976 version of section 382, to stock purchases and reorganizations. If the shareholders' interests are viewed as indirect ownership of the assets inside the corporate shell, a purchase of outstanding stock divides the loss company's capital, whereas a merger with a profit company creates an expanded pool of capital. There is no equivalence between these two cases that justifies the same scaledown based solely on a uniform percentage of shareholder continuity. A 10 percent continuing interest by the loss company's owners in their own company after a sale of 90 percent of the outstanding stock of the company to an outsider is worth less than a 10 percent continuing interest by these owners after a merger of their company with another company.[23] The old shareholders' continuing indirect interest in their company's assets after a merger is also not accurately reflected by a scaledown according to the

[17]Presumably, under such a "mandatory section 338 election," accumulated earnings and profits would also disappear.

[18]353 U.S. 382 (1957).

[19]Section 332(a).

[20]Reg. § 1.382(a)-1(h)(6).

[21]For example, section 351 transactions and type (B) reorganizations are not covered at all. In a triangular reorganization, the loss company's former owners need only receive stock in the parent company worth 20 percent of the value of the loss company (rather than 20 percent of the parent company).

[22]Most of the litigation under section 382(a) has involved the question of whether a business has been continued or discontinued in specific factual settings.

[23]Suppose for example, that loss company L, having $1 million net worth, merges with profit company P, having $9 million net worth, for 10 percent of the common stock of surviving company, LP. L had a loss carryover of $10 million. Under present law, the carryover would be reduced to $5 million. If the same percentage scaledown were applied to a taxable sale of a loss company's stock, and the shareholders of L sold 90 percent of their stock to a new investor for cash, L's carryover would also be reduced to $5 million. But these two transactions are not the same economically. After the merger, L's shareholders continue to own the same value they owned before ($1 million), while after a taxable sale of 90 percent of their stock for cash, the value of their interest in the loss company is reduced to $100,000. The dollar amount of L's carryover should not be reduced by the same amount in both cases.

shareholders' percentage interest in the combined enterprise.[24]

4. Free Trade. Those who would remove all restrictions against selling and buying tax carryovers do not object to a sale of disembodied attributes apart from business assets, but simply want the sellers to be compensated as fully as possible. In this view a new owner of a loss company should not have to continue the existing business, nor worry about how many former proprietors continue to hold an equity interest. The main point is that the owners of a loss company will possess greater bargaining power, free of legal uncertainties which require heavy discounting, to receive full compensation for their company's losses if they can freely sell them, while also reducing the "windfall" to a new investor.[25] Even under free trade, however, a buyer will discount his purchase price to reflect the risk that he may not earn sufficient income to absorb the carryover, and to reflect his delayed receipt of the benefit until future years. In addition, even if a buyer is paying solely for a loss or credit and for no productive assets, he will also pay less than the present discounted value of the carryover, because otherwise it will merely break even.

Existing law does not reflect any clear concept of the evil to be prevented.

A more substantive difficulty is that free trade departs radically from the averaging rationale for carrybacks and carryovers. Free trade does not require that the new owner earn any income from the company's nontax assets, since the survival of carryovers does not depend on the loss company's business or on the income-earning potential of its assets. Under these circumstances it is not clear why the loss company deserves to be reimbursed for the tax value of its unused losses, even if the losses resulted from incentive-type deductions, tax elections or other timing features. If carryovers are allowed in order to average the income and loss of business assets, or to encourage new enterprises or risk-taking, or to alleviate the competitive effects of business cycles, free trade will assist none of these objectives if the buyer can obtain carryovers to shelter future income from unrelated assets. Free trade also creates a disadvantage for businesses which compete with a business buying a carryover. If profit company P can acquire loss company L and use L's carryovers to shelter P's income, the amount paid for the carryovers represents, in effect, tax dollars that P would otherwise have paid to the Treasury. These dollars are diverted to reimburse private taxpayers for their business losses or for tax incentives (in the form of accelerated deductions) intended for their corporation. The policy question is whether tax dollars should be diverted in this way to what are, in many cases, inefficient or "real" money-losing enterprises. Since P will necessarily pay less than the present value of the carryovers, P's taxes will be lower than the taxes paid by its competitors. These effects suggest that more serious policy considerations are involved than merely the administrative simplicity of a free trade system, or the likelihood that without restrictions the sellers of a loss will be more fully compensated.

On the other hand, we would say that if loss or credit carryovers accompany a sale of a going business or other elements of real economic value, the negotiation of attributes might be defensible as merely an incidental part of the entire "package" being transferred. Under those conditions it would not be wrong to let the buyer pay something for unused losses or credits. Unless our tax system bars all inheritance of tax attributes (including earnings and profits), some permission to "sell" tax attributes must exist, so long as the primary feature of the overall transaction is a transfer of real economic values.

5. Refundability. Some economists and academics argue that we could solve the administrative and legal difficulties of policing loss carryovers if the Treasury simply reimbursed business taxpayers directly for operating losses and unused credits. The rate at which these items would be "refunded" in cash would be separately decided, but would reflect a presumed tax value of the loss or credit.[26] This amount would then be paid directly to the sufferer of the loss rather than routed through a third party, as under free trade.[27]

The main argument for refundability appears to be that a patchwork system of refundability already exists for established and diversified corporations and for affiliated groups which file a consolidated return.[28] The opportunity to obtain a refund of past profits or of the profits of another division or subsidiary, it is said, can be viewed as existing reimbursement by the government through a decreased tax on those profits. The tax system would be more "neutral," it is argued, if these favoritisms were eliminated. Our present tax system allegedly also distorts investment decisions away from risky projects by the prospect that the investor will not be able to fully deduct his losses; the existing system also encourages corporate mergers in order to obtain carryovers; and it devalues the tax benefit of carryovers whose use is deferred in a period of long-term inflation. The remedy for all these "defects" is to allow taxpayers to recover currently the tax value of their losses and credits. The tax system would also be more neutral, it is said, if it disregarded the taxpayer's characteristics that are extraneous to a par-

[24] See footnote 42, *infra*.

[25] See, e.g., New York State Bar Association Tax Section, "Report on Section 382 of the Internal Revenue Code as Amended by the Tax Reform Act of 1976," 31 The Tax Lawyer 283, 286 (1978); Aidinoff, "Utilization of Acquired Net Operating Loss Carryovers and the Tax Reform Act of 1976—A Face Lift for Section 382," 55 Taxes 874, 886-888 (1977).

[26] Refunding might occur annually through a payment of part or all of a loss or unused credit directly to the loss company. Instead, the refund might be paid at the date of a merger or other acquisition of the company, or on sale of a certain percentage of its stock, or at liquidation, or at the date unused carryovers would otherwise expire.

[27] Free trade is perhaps less radical than refundability, because the latter system compensates the loss company or its shareholders without a need for any positive income. Under free trade a buyer will benefit from loss carryovers only if his business earns income (or incurs tax liability) to absorb the attribute.

[28] See Campisano and Romano, "Recouping Losses: The Case for Full Loss Offsets," 76 Northwestern Univ. L. Rev. 709 (1981).

ticular investment project. Refundability would also be more cosmetic than free trade, because it avoids any public "marketing" of tax benefits.

...for advocates of a business continuity test, more than merely continuing a business must be required.... A change in stock ownership seems equally necessary.

The difficulty with all of these arguments is that refunding rests on an incorrect view of many of the basic principles of our tax system. In practice, the idea would also damage the general self-assessment process. The fact that our present system "favors" established, diversified, and/or affiliated companies is less a result of the loss carryover rules than it is of the "one basket" treatment of income and expenses in our tax law. Our system basically taxes *persons* as owners of an aggregate income stream and not the separate income from a particular business or venture.[29] Even in a tax-free world, a diversified company would fare better economically than a one-product company that loses money.[30] Our tax system therefore cannot be held responsible for favoring diversified over undiversified businesses. The real question is whether the tax system should be used, via refunding, to make profitable, taxpaying persons subsidize businesses that incur real economic losses, or to reduce the advantage which diversified and affiliated corporations now enjoy. Whether the loss carryover rules should be used to do this involves nontax policy, but those rules should be viewed as a potential means for changing the one-basket income tax system rather than as part of any loss carryover problem. The tax system would also not operate neutrally if profitable taxpayers effectively subsidized loss businesses through payments from general revenues. It might be predicted, in fact, that use of general revenues to subsidize money-losers might further weaken taxpayer morality (as occurred with safe harbor leasing), and tip the tax system even further away from effective revenue-collecting.

The argument that refundability reduces the advantage of an established business over a new business may also be questioned. A new business obviously lacks earlier profit years to which a current loss can be carried to create a refund. However, the established business that enters a new field, loses money, and generates a refund of past taxes also pays no tax for past years; in this respect the established business is put in the *same* position as the new business—both pay no tax for pre-loss years. The fact that the established company ends up with past earnings which are in effect untaxed reflects the nontax fact that it has been in business longer than the new company. The tax system, however, has not favored the old company over the new company in terms of competitive equality; both companies are in the same tax position, *i.e.*, no tax incurred for pre-loss years and an opportunity to carry the current loss to future years. And insofar as multi-product companies benefit from accelerated deductions more than single product companies do, this is another result of our basic one-basket income tax system; refundability should be compared with direct government subsidies as a delivery mechanism if a change in fundamental concepts is desired.

...a business continuity test creates difficult factual and definitional problems and also an uneconomic stress on continuing an activity that, in many cases and apart from taxes, ought to be ended.

Our tax system in fact confers a generous subsidy in not imposing any tax on a taxpayer who suffers a net operating loss while still providing government services to that taxpayer. In this respect, the income tax system is already more generous than an excise tax system, which imposes taxes regardless of the existence of net income or loss, or than a private landlord or other creditor who normally demands payment regardless of his debtor's net income or loss. It is far from clear that a social, economic, or political consensus exists for using public funds to do any more for a money-losing business in the form of reimbursing even part of its losses.[31]

6. Income Versus Capital Limitation. In 1956, the taxation subcommittee of the House Ways and Means Committee appointed a group of private practitioners to recommend amendments generally to subchapter C.[32] The Advisory Group Report[33] recommended a new statutory rule that the carryovers of a loss corporation be limited to 50 percent of the amount paid by the buyer for all the stock (or which would have been paid for all the stock at the rate at which 50 percent or more was purchased). Reorganizations would have been treated as

[29]Thus, a tax-exempt organization owes no tax on its income not because of the characteristics of the income, but because of the characteristics of the recipient organization. In general, and with exceptions, individuals and corporations are permitted to net their income and deductions regardless of the source of particular income and deductions.

[30]Thus, if a one-product widget company loses $100 while a two-product company also loses $100 making widgets but earns $100 making gadgets, and assuming a tax-free economy, the two-product company will come out economically ahead because it will have zero net worth while the other company will suffer a $100 deficit.

[31]Some also argue that the government should share equally in profits and losses and that refundability will achieve this result. Yet if the government collects $46 from a $100 profit and reimburses another taxpayer $46 for a $100 loss, the after-tax cash flow to the profitable taxpayer ($54) nearly equals the after-tax cash flow to the loss taxpayer ($46). In this light the government is not the taxpayer's "partner"; it is more like a guarantor or underwriter.

[32]Members of this group were Norris Darrell, chair; Kenneth W. Gemmell; C. Rudolf Peterson; Samuel J. Lanahan; Edwin S. Cohen; Leonard L. Silverstein; and Mervin K. Collie.

[33]The revised report was submitted on December 11, 1958.

purchases under this rule. For example, if a loss company had carryovers totaling $200,000, the buyer would have to pay (in cash or stock) at least $400,000 to obtain all the carryovers. Since the tax benefit from the carryovers was $100,000 (assuming a 50 percent corporate tax rate), the buyer would have to be paying at least $300,000 for something else, i.e., presumably nontax, income-producing assets. If the buyer paid only $100,000, he could use only $50,000 of carryovers producing a $25,000 tax benefit. Such an acquisition would not make sense for the buyer and, under this idea, would not be rational unless the loss company had other elements of real economic value worth at least three times the tax benefit from the carryover.

Keying the amount of carryovers solely to the degree of change in ownership is also flawed if a uniform scaledown applies, as under the 1976 version of section 382....

The basic aim of the Advisory Group was to allow loss carryovers if the buyer was paying primarily for business assets, and to tie the amount of carryovers to the earning potential of the loss company's assets as of the time its ownership changed. As explained by C. Rudolf Peterson,

> "This would also, you might say, cut a carryover down to size in that if there was a substantial business and you were willing to pay for it, if it had an enormous carryover you would not be losing the whole thing, but would get some part of it, which you might say would be in a way related to the business of the size and prospects it has at the time the ownership changes hands."[34]

In 1982, an alternative proposal was offered by a different group of scholars and practitioners as part of an American Law Institute study of subchapter C.[35] The ALI suggested that, in the case of reorganizations, the old losses of a merged loss company should be allowed each year up to a fraction of the income of the survivor company equal to the percentage of total common stock received by former owners of the loss company.[36] Where preferred stock was issued, or where a new investor purchases more than half of the loss company's stock from existing shareholders, the ALI proposal would limit annual use of the company's carryovers to the after-tax income which the preferred stock or other purchase price would yield at an imputed rate of return on the consideration.

Where less than all of a loss company's outstanding stock is purchased by new owners, a two-step rule would apply. Loss carryovers would be allowed against (a) an interest-like rate of return on the consideration paid by the buyer to the selling shareholders, plus (b) a percentage of future earnings reflecting the continuing ownership of the shareholders, if any, whose stock was not purchased. For example, if a new owner bought 80 percent of the stock of a loss company for cash from existing shareholders, the carryovers would be allowed in the amount of a specified annual return on the purchase price plus 20 percent annually of future corporate earnings reflecting the continuing minority interest.

Both the Advisory Group and the ALI would abandon a business continuity test and a shareholder continuity test. The objectives of both proposals are also the same, although the mechanical rules proposed by each differ. Both proposals aim, at bottom, to limit loss and credit carryovers in the hands of new owners to the income which the loss company's assets might reasonably have expected to earn as of the date of the merger.[37] The Advisory Group would limit carryovers by reference to the price paid for the loss company's assets or stock; the ALI would allow the amount of carryovers to offset each year the percentage share of income allegedly "allocable" to the loss company shareholders' continuing stock interest. ALI points out that if the loss company did not merge with another business, or if it cashed out its existing assets and reinvested the proceeds in an investment paying a fixed rate of return, it is clear that under present law its carryovers could offset those earnings (but no more). Both approaches in effect view a merger, or a sale and purchase of stock, as a form of "investment" of a loss company's assets (capital), after which carryovers should be permitted to offset future earnings deriving from this capital but no more. The expression of this idea builds on the concept originally put forth by the Advisory Group in 1958. Both approaches prevent trafficking in losses because the price which a new owner "pays" to the loss company's shareholders via stock, cash, notes, etc. must exceed the maximum 46 percent tax saving which can be obtained from the carryovers. So a buyer will have to pay primarily for other assets in addition to tax benefits.

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[34] Testimony of C. Rudolf Peterson, Hearings before the House Ways and Means Committee on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code, 86th Cong. 1st Sess. 421 (Feb. 26, 1959).

[35] See American Law Institute, Federal Income Tax Project: Subchapter C, Proposals of the American Law Institute on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions (1982). The reporter for this project was Professor William D. Andrews of Harvard Law School. The proposals relating to special limitations on loss carryovers and related topics appear on pages 198-301 of the volume.

[36] Thus, in a merger where 10 percent of the common stock of the acquiring company is issued to shareholders of the loss company, the full amount of loss carryovers would survive the merger but could be deducted yearly against only 10 percent of the earnings of the acquiring company until the carryovers otherwise expire.

[37] In the case of a merger, the ALI says it also purports to approximate the results of a "joint venture" between the loss company and the profit company or other merger partner. We will comment later on the validity of this analogy. A purchase of the outstanding stock of a loss company does not expand the capital of the company at that time, but if a new owner acquires over 50 percent control, he is *potentially* likely to contribute new assets into the company. The ALI proposal would therefore limit carryovers when more than 50 percent of a loss company's stock is sold to new investors on grounds of the *potential* expansion of assets.

III. A PROPOSED PURCHASE PRICE RULE

A. In General

Standing on the shoulders of those who have gone before, we have tried to discover a sensible and practical approach to the loss carryover problem. So long as Congress allows tax attributes to cross lines of corporate fusion and to survive stock sales and purchases (except where the taxpayer elects otherwise under section 338), we need a rule to prevent unrestricted dealing in losses and also their total destruction upon a change in control of a loss company. In our opinion, carryovers should not be conditioned on continuation of any particular business. Nor should the amount of carryovers depend directly on the percentage of continuing old shareholders.

A neutral rule would allow a new owner of a loss company to use no more carryovers than the loss company itself could reasonably have expected to use based on the size and earnings "prospects" of its assets at the time of sale. This is the common objective of the Advisory Group and ALI proposal, whose seminal expression appears in Rudolf Peterson's statement quoted earlier. If we use a gross (capital) limitation, the ceiling on carryovers will be equal to the value of the loss company at the time a major change in control of its stock occurs. On the other hand, if we seek an annual income limitation, the annual ceiling will be the after-tax income which the purchase price will yield at an assumed rate of return.

Unless our tax system bars all inheritance of tax attributes . . ., some permission to 'sell' tax attributes must exist, so long as the primary feature of the overall transaction is a transfer of real economic values.

For reasons to be explained, we believe that a capital limitation is better in achieving the desired objectives. If all the stock or assets of a loss company change hands, losses should be allowed in an amount equal to (and no greater than) the purchase price paid for the stock or assets of the company. This rule would apply uniformly to taxable sales and purchases of stock of a loss company, tax-free reorganizations, new issues of stock in exchange for new money or property, and changes in control by a redemption of existing shares. This approach is neither "liberal" nor "strict," but merely includes rules which flow naturally and rationally from careful observation of the round world. Inevitably, such a rule (like the ALI proposal) will be triggered by changes in the stock ownership of a loss company. But our proposal would not limit carryovers according to the degree of change in shareholders (as under present law); it would use changes in ownership only to determine when a loss company's assets have been combined with another company's assets (currently or potentially) to warrant immediate action to prevent "trafficking" in losses.

There are two focal points that should be kept in mind: (a) the quantity of the loss company's assets, and (b) the quality of these assets. We will attack the quantitative problem first, assuming we are dealing with loss companies that have only income producing business assets and no cash or investments.

B. Objective Factors

How do we ascertain how much loss the company should be permitted to use after a transfer of its assets or stock? On the basis of some simple and practical assumptions, the fair amount of losses to be allowed can be readily determined.

Some economists and academics argue that we could save the administrative and legal difficulties of policing loss carryovers if the Treasury simply reimbursed business taxpayers directly for operating losses and unused credits.

Assume a buyer who desires to receive a $1 million annual income stream after taxes in a 10 percent market where the corporate tax rate is 46 percent. If the buyer considers acquiring a company having no loss carryovers, he will pay up to $18.5 million for a company having $18.5 million in net assets.[28] The purchase price represents the present value of the annual after-tax income stream to be received in the future. The buyer could also obtain the same annual after-tax income by buying a company having loss carryovers and fewer business assets. If the broker showed him a company having only $10 million in net assets but abundant loss carryovers lasting forever, the buyer could obtain the same $1 million income annually for his $18.5 million purchase price ($1 million tax-sheltered earnings yearly on $10 million assets). An outsider cannot determine what deal the buyer and seller made, however. We do not know what annual after-tax income stream the buyer desires; or why he may choose to acquire the loss company or what its assets or carryovers are; or how the parties allocated the purchase price between assets and tax benefits. Nevertheless, an objective rule is needed to assure that if the buyer chooses the loss company, he pays primarily for nontax assets. This rule can be based on our knowledge of (a) the prevailing rate of return on investments generally, (b) the current corporate tax rate, and (c) the acquisition price.

As noted, the purchase price paid by the buyer of an entire company represents the present value of the expected future after-tax income stream from the acquired company's assets. One who buys all the stock of a corporation that has no losses, at a given price, P, expects that company to have assets equal in value to the purchase price which will yield a stream of annual taxable income at an expected rate of return *ER* equal to P x *ER*. At a tax

[28]The taxable income required to produce $1 million after taxes is $1 million divided by .54 (assuming a 46 percent corporate tax rate), or $1,851,850. In a 10 percent market such a stream of after-tax income is worth 10 times that sum, or $18,518,500.

rate of T, this produces an *after-tax* income stream equal to P x *ER* x (1-T). It is always true that:

P = present value of [P x *ER* x (1-T)] per year, forever.

If, however, a corporation has abundant loss carryforwards for 15 years (which we will treat as forever), its after-tax income, P x ER x (1-T), will also be its pre-tax income *and will also equal* the amount of annual loss carryover to be deducted. Loss carryovers will produce the same after-tax income stream as a nonloss company from business assets (*BA*) worth less than P as follows:

$$BA \times ER = P \times ER \times (1-T)$$

The buyer may choose to obtain his desired after-tax income stream by acquiring a nonloss company having more assets or a loss company having fewer assets but tax loss carryovers. How do we prevent abuse if he chooses to acquire the loss company?

If there had been no change in control of the loss company and no new assets are transferred into it, the maximum amount of loss it could use each year would equal the income produced by its productive assets, which is either [*BA* x *ER*] or [P x *ER* x (1-T)], indifferently. Thus, it would seem appropriate to allow a loss company, after an actual or potential mixing of its assets with another group of assets, to use the same annual stream of loss carryovers, namely, P x *ER* x (1-T), which it could have used if no change in ownership had occurred. It follows that the nontax assets acquired by a buyer who wishes a desired after-tax income stream, and chooses to obtain that stream from a loss company, must be at least P x (1-T).

Under an ALI-type income limitation, the annual carryover deduction would be limited to the after-tax yield at the prevailing rate on the purchase price paid for the loss company.

Example: A buyer purchases all the stock of a loss company. P = $18.5 million. ER = 10 percent. T =46 percent. Under an ALI limitation, the annual deduction is limited to the after-tax income which the purchase price would produce in a 10 percent market and with a 46 percent tax rate. This is $18.5 million x 10 percent x (1-.46) =$1,000,000 annual taxable income to absorb carryovers. Minimum assets: $18.5 million x (1-.46) = $10 million.

For several reasons it seems to us simpler and more equitable to convert this annual stream of loss deductions into a present value. Identities in the above formulas give us a present value of an annual stream of losses of P x ER x (1-T) equal to the purchase price, P, paid by the buyer. It is apparent that when all the stock of a loss corporation, which has only business assets, is purchased for P dollars, the amount of total loss carryovers which the corporation should be permitted to use at once is 100 percent of the acquisition price.[39] This is the present value of an imputed future income stream from the company's assets, and can be referred to as a capital limitation. In the above example the total limitation on losses would be $18.5 million. At a 46 percent corporate tax rate this deduction cannot be worth more than $8.5 million to the buyer. Accordingly, the buyer clearly will insist on obtaining at least $10 million in nontax assets, just as he would under an income limitation.

C. Operation of the Limitation

It is easy to see that the annual benefits allowed under an income or capital limitation are essentially the same. In the example given above, the comparative results would be:

(a) *Income limitation*

Annual deduction = $1,000,000. This is also the annual after-tax income stream. This amount will yield an after-tax increase in annual income of $1,000,000 x .46, or $460,000. This income lasts up to 15 years.

(b) *Capital limitation*

Current deduction = $18,500,000.

If we assume that the entire deduction is taken currently and the tax saving ($8,510,000) is invested at a 10 percent rate, the annual increase in the after-tax income stream will also be $460,000, computed as follows:

$8,510,000 x 10 percent x (1-.46) = $460,000.

This income stream goes on forever.

If we assume that 15 years is forever, the results under both rules are the same. The increase in the company's annual after-tax income stream ($460,000) is the same as the maximum increase in annual after-tax income which the carryovers would have created for the loss company had the sale not occurred and if no new assets were contributed to it. The corporation will never be able to exploit a loss which it could not have exploited before the ownership changed hands.

Both the Advisory Group and the ALI would abandon a business continuity test and a shareholder continuity test.

Notice that although in reality we do not know what assets the loss company owns, the buyer in our example will have had to pay at least 54 percent ($10 million) of the purchase price for the assets and no more than 46 percent ($8,518,500) for losses.[40] If the loss company had no assets and were merely a shell, a buyer who pays 10 cents on the dollar, hoping to obtain $50 million in carryovers, will obtain only $5 million under our proposal and would lose money. The maximum tax benefit he could obtain by contributing his own profit-generating assets into the company is 46 percent of $5 million, or

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[39]The resemblance to the 1958 Advisory Group proposal is obvious, except that we would eliminate the requirement of a 3:1 ratio between productive assets and tax savings. By allowing carryovers equal to the acquisition price, we ensure that, at a 46 percent maximum corporate tax rate, the buyer will insist on getting at least 54 percent of his purchase price in nontax assets, just as he would under the income limitation proposed by the American Law Institute.

[40]Under both an income or capital limitation the buyer will not pay more than 185 percent of the value of the loss company's nontax assets. Otherwise he will lose money economically. If, in our example, the buyer paid $20 million for the loss company's stock, the company could use $20 million in carryovers. However, the maximum tax saving from use of that amount of loss carryovers would be $9.2 million. Since the buyer also obtained $10 million in nontax assets, he lost $800,000 on the transaction.

$2.3 million. For that the buyer would have paid $5 million.

In the real world, a buyer in our example who pays $18.5 million for the stock of the loss company has merely broken even. Since he has paid full value for the losses which the company itself could have exploited, we will allow him all of those losses (but no more). However, a real buyer will want to do better than break even. If a good bargainer buys all the stock of the loss company in our example for $15 million, believing he can (but for a tax obstacle) obtain $10 million in assets and $50 million in loss carryovers at 10 cents on the dollar, the annual deduction under the ALI rule will be $810,000 and the annual tax saving for 15 years will be $372,600. A capital limitation will allow the company an immediate deduction of $15 million, and if we assume that the entire deduction is used at once and the whole tax saving ($6.9 million) is invested at a 10 percent rate, the annual increase in the company's after-tax income stream will also be $372,600. This is less than the increased income ($460,000) which the company would have received from its own carryovers before the sale of stock. But since the buyer paid less than full value for the usable loss, it is fair to cut down the ultimate after-tax benefit to the company under his ownership (as an income or capital limitation would do).

D. Comparison and Comments

A purchase price limitation has all the advantages and none of the disadvantages of an income limitation. It has its own special advantages. It is simpler to understand, to draft, and to apply in actual practice.

1. Rationale. A purchase price rule avoids the inaccurate rationale offered by the ALI that carryover losses will be deducted against income "allocable" to the loss company's shareholders, or that a merger can be analogized to a joint venture between loss and profit companies. In a statutory merger the benefit of carryover-sheltered income inside a corporation flows pro rata to all shareholders, and in reality the loss company's shareholders are selling part of their interest in their company's losses to the other company's shareholders.[41] The setting of exchange ratios reflects a present value evaluation of the losses by the parties in order to divide their tax benefit between the seller and the buyer. The better rationale for both an income limitation or a capital limitation is that the buyer can acquire and use no more losses than the loss company's assets were otherwise likely to have earned, *regardless* of the percentage division of benefit from the losses between the old and new owners of the loss company's assets.[42] A capital limitation thus carries out more logically the American Law Institute's own objective to limit carryovers by the profit potential inhering in the loss company's nontax assets.

2. Neutrality. A capital limitation might be thought to encourage some acquisitions which might not otherwise occur by allowing a buyer to deduct loss carryovers in full immediately against the buyer's own income. Thus it may be feared that loss companies that are near the end of their carryover period and unable to use their own benefits will be tempted to advertise for a buyer who has current income. A way to discourage such sales is to stretch out the buyer's use of the carryover.[43] In the real world, however, the feared abuse is not likely because, with extension of the carryover period to 15 years, a failing company will expire before its loss carryovers do. In practice, we think both alternative rules will be equally neutral in neither encouraging nor discouraging an acquisition.

A capital limitation will also not destroy or adversely limit carryovers which reflect accelerated deductions such as ACRS, but will in effect convert the potential continued use of the carryovers reflecting those deductions into a present value which may be utilized following a change in control of a loss company.

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[41] A merger is essentially an exchange by the shareholders of each company of an indirect interest in part of their company's assets for an indirect interest of equal value in the other company's assets. Assume that loss company L, worth $100, merges with profit company P, worth $900, in exchange for 10 percent of the stock of the survivor, LP, whose total net worth after the merger is $1,000. Because corporate assets and the income they produce inside a corporation are not specially allocated between or among the shareholders, the tax benefit of a carryover flows out pro rata to all shareholders, including former owners of the profit company. The $100 worth of LP stock received by L's former owners in the example does not represent a continuing interest in 100 percent of L's former assets, but rather represents a 10 percent interest (worth $10) in L's former assets plus a 10 percent interest (worth $90) in P's assets. The tax benefit of a carryover against, say, 10 percent of LP's income is not confined to L's former owners. P's owners receive 90 percent of the benefit of the 10 percent income share supposedly "allocable" to L's former owners under the ALI proposal.

The ALI Reporter acknowledges that carryovers will not actually be deducted against a segregated portion of post-merger earnings but will be deducted against the earnings generally. However, the Reporter says "it does not seem unreasonable to suppose that [the deduction's] value will get taken into account in setting exchange ratios, with the result that shareholders of the loss corporation will ultimately be the major ones to benefit from allowance of the deduction." ALI Report, p. 226. The Reporter seems to see that, in reality, the loss shareholders are selling an interest in their company's tax attributes, but he fails to see that if those shareholders end up with less than 50 percent of the surviving company, the other company's shareholders are the major ones to benefit from the deduction.

[42] Oddly, after a merger, ALI would look to the percentage of stock in the survivor held by persons who were shareholders in each loss year when losses were incurred. After criticizing the notion that shareholders beneficially "own" a corporation's losses (ALI Report, pp. 220-225), it is inconsistent to tie an income share to the degree of continuity of stock ownership by the same persons between each loss year and carryover year. Even if ALI is striving for continuity of *capital* between these years, such a rule is inconsistent with the rationale of viewing a merger as a new investment of the loss company's existing capital. Also, why trace old assets which may have long since ceased to exist? Such a rule would also be incredibly difficult to administer in practice. A purchase price rule avoids ALI's over-theorizing and unnecessary complexities.

The example in footnote 41 also shows the fallacy of a shareholder continuity test under present law. The L shareholders' 10 percent interest ($100) in LP consists of a continuing 10 percent interest ($10) in L's assets plus a 10 percent interest ($90) in P's assets. As a percentage of the combined enterprise, the L shareholders' continuing indirect interest in their former assets is only 1 percent (10/1000) rather than 10 percent.

[43] One possibility is to allow, say, 20 percent in the first year after a sale, 40 percent cumulatively after the second year, 60 percent after the third year, 80 percent after the fourth year and 100 percent after the fifth year.

3. Self-Regulating Features. A single purchase price rule is also preferable to separate rules (as proposed by ALI) for purchases and reorganizations. Under a purchase price rule Congress would not have to decide on a rate of return, and how to vary the rate, to be imputed to a purchase price. The parties' own deal automatically reflects a discounting to present value, and the higher the discount rate used by the parties themselves the lower the purchase price, and in turn the lower the amount of carryovers allowed. This rule is thus self-regulating (unlike the ALI rule). An income rule also creates its own technical complexities in calculating the appropriate income share for mergers and continuing minority shareholders; indeed, the ALI report spells out two alternatives in this regard, one of which involves circularity in allocating after-tax earnings. These difficulties would be entirely avoided by a capital limitation.

4. Valuation. Valuation of notes or stock may be required in some cases under an income or capital limitation. Under the ALI proposal, for example, if the acquiring company in a merger has more than one class of stock outstanding, it will be necessary to value the stock received by the loss company's shareholders in order to determine the income share against which carryovers can be deducted. But the difficulties in this regard should not be exaggerated. Under a purchase price rule, where the buyer pays in kind, i.e. stock, notes or other property, valuation questions will be limited to relatively few situations. Publicly traded stocks or notes are readily valued. In taxable sales between closely held companies, values arrived at in arm's length negotiating between parties with adverse interests are normally close to real market values, and in any case the seller must ordinarily determine the value of property received in order to report his gain or loss for tax purposes.

If less than all of a loss company's stock is bought by new owners, we would "gross up" the purchase price for the portion purchased and determine the entire value of the company by reference to the same price per share, which is the best indicia of value. The Advisory Group first proposed this in 1958. It would avoid the ALI's complex two-step rule for partial purchases. A gross-up will automatically deter abusive undervaluations of the assets and tax attributes of the loss company because the lower the amount paid by the buyer, the lower the total acquisition value of the company and the lower the survivable carryovers.[*] The buyer's incentive under a gross-up rule will be to increase the amount he pays, to come closer to a fair price for the entire company. A gross-up rule will also induce a buyer not to utilize unusual debt instruments, such as high face amounts with balloon payments and/or increasing interest rates, because value-depressing provisions such as these will instantly reduce the value of the purchase price and reduce the grossed-up acquisition value. Because the taxpayer will be induced to argue for a *higher* purchase price, and the Internal Revenue Service for a *lower* price, this reversal of the usual adversary positions will pressure taxpayers to utilize more conventional debt instruments and avoid arguments over value.

...our proposal...would use changes in ownership only to determine when a loss company's assets have been combined with another company's assets...to warrant immediate action to prevent 'trafficking' in losses.

5. Exactness. A purchase price rule will allow carryovers to be used normally as fast as income can be generated to absorb them, rather than against an artificially limited income share each year. However, the total amount of deductions will be based on the present value of the future income stream as envisioned when the acquisition occurred, rather than as the parties manipulate assets thereafter. Some may claim that an income limitation is preferable on grounds that allowing losses against the actual income stream (rather than a discounted present value) rewards a new investor who succeeds beyond expectations in turning around a failed business. This argument brings back a nonneutral tax rule and perversely rewards a person who least needs it. It simply gives the buyer an undeserved windfall. If such a windfall is desirable, we should shift entirely to a business continuity test and let carryovers ride up, or down, depending on the buyer's turnaround efforts.

Some also argue that a purchase price rule only "approximates" the income produced by the loss company's assets, while an income limitation is "exact." It is certainly not true that the income rule applies only to actual earnings from the loss company's assets, since even if these produce no income after a sale, the ALI rule would still allow deductions against a percentage of the other merger partner's assets. Further, most sales and mergers are closed transactions based on present values which the parties negotiate at the time of sale. Unless and until contingent stock deals become the norm rather than the exception, a capital limitation is more consistent with actual business practice and would neither increase—nor decrease—the carryovers depending on actual earnings from the loss company's assets or changes in the marginal tax rate.

E. Business Assets v. Investment Assets or Cash

The qualitative issue is whether the loss company or its successor should be entitled to use the same amount of carryovers it could have otherwise used, regardless of the kind of assets it owned when the sale occurred, or whether the statute should focus on income prospects from business assets only. This issue tests the basic rationale of an income or capital limitation. It also bears on abuse possibilities where the assets of a loss company are artificially inflated before a sale by a contribution of business assets by the owners of the loss company. Potential new owners might also direct the company to use its surplus cash to purchase business assets desired by the buyer. Or, after acquiring assets or stock, the new owners may promptly dispose of all of the loss company's assets and use the proceeds in their own preexisting business.

[*]The Advisory Group considered a two-part rule in lieu of a gross-up, allowing carryovers on account of income allocable to stock retained by minority shareholders. This idea was rejected on grounds that "the retained carryover so measured would benefit principally the new owners, not the old." Revised Report on Corporate Distributions on Adjustments, Subchapter C Advisory Group, December 11, 1958, p. 98.

One possibility is to subtract cash and investment assets held by the loss company on the date of sale, business assets acquired within a short period before the sale, and the proceeds of asset dispositions within some period after the sale, from the aggregate purchase price.

If the basic idea behind a limitation is to allow carryover of attributes in an amount equal to those the loss company could have otherwise used, however, it is arguable that we should not subtract investment assets, because present law would not have prevented the loss company from applying its carryovers against investment income, even if that had become its only earnings. A business asset exclusion might also induce a failing business to hold on to properties which, economically, it ought to sell. And, without special rules, there can be definitional problems in distinguishing between business and investment assets.

The corporate identity issue underlies much of this, along with abuse possibilities. Assume, for example, that the Fig family owned all the stock of a corporation which owned a brewery that lost money for many years. Losing hope that the business would recover, the company sold all its brewery assets and purchased a portfolio of stocks and bonds and a medium-sized apartment house. The Newton family then buys all the stock, intending to place a profitable construction business in the loss corporation. It is plain that the new owners are entirely different, the new business is different, and the new business assets are different under the Newtons. The only continuity lies in the corporate charter and in the possibility that the stock certificates are still printed on the same color paper. In the extreme, if the company's assets had been reduced entirely to $1 million cash and the Newtons paid $1 million cash for all the stock, the purchase really cost the buyers nothing. A spectrum of other assets nearly as liquid, such as stocks and bonds, can also exist, along with other investment assets more or less liquid and more or less passive.

. . . the purchase price paid by the buyer of an entire company represents the present value of its expected future after-tax income stream from the acquired company's assets.

If no concern is shown for these items, and for the possibility of pre-sale and post-sale movements of assets, great slippage will occur in the effectiveness of an income or capital limitation. In *Alprosa Watch*,[45] two days after two new owners bought all the stock of a loss company for $22,000 cash, all the corporate assets (used in a glove business) were sold for $22,000 cash plus $10,000 assumed liabilities, and the proceeds were used to begin a watch business. The court allowed the corporation under its new owner to apply operating losses from earlier years against the later profits. The new owners obviously purchased the loss company in lieu of creating a new corporation because of the tax benefits, which, the facts show, cost the buyer nothing. Was the corporate "person" the same after the shift to completely new owners, name, location, assets and business? Would an income or capital limitation ensure that the buyer in this case pays primarily for nontax assets?

A purchase price limitation has all the advantages and none of the disadvantages of an income limitation. It is simpler to understand, to draft, and to apply in actual practice.

Most cases may not be this extreme. But there is a continuum of identity loss and potential abuse. Even though a loss company could have clearly used its carryovers against investment income if no acquisition had occurred,[46] some compromise with pure theory seems essential. We would subtract from the value of a loss company all cash and cash equivalents owned at the date of the transaction; the value of any personal holding company-type assets whenever acquired; and business assets acquired as a contribution to capital or in exchange for stock within 24 months before the sale. Proceeds from a sale of business assets during five years after the transaction (other than in the ordinary course of business) would also be subtracted. To alleviate hardship, the Treasury would be allowed to exempt taxpayers who could show that the company recently acquired property as part of a legitimate plan to solve serious financial difficulties.[47] These ideas are not intended to require a *Libson Shops* type of business continuity; but some level of generic business activity must be required if corporate identity is to be preserved and either an income or capital limitation is to achieve the goals we have outlined.

F. Summary

A purchase price limitation is simpler to draft and apply to actual transactions than an income limitation. It automatically assures that the loss company will have business assets worth more than half the purchase price, and that carryovers will be usable by the new owner in no greater amount than those assets would have produced without any sale of the company.

[45]Footnote 12, *supra*.

[46]Cf. Rev. Rul. 67-186, 1967-2 C.B. 81 (under section 382(a), if a new party buys more than 50 percent of the outstanding stock of a corporation which owns only portfolio securities, the loss carryovers produced by a discontinued business will not be allowed).

[47]The Advisory Group would have subtracted assets acquired within six months before the sale. The ALI proposal, by contrast, would exclude all capital contributed to the loss company after the year when each loss within the carryover period was incurred. This impractical idea is also inconsistent with the ALI's own basic rationale that a merger or purchase of more than half of a loss company's stock is a discrete event representing a pooling of capital as of that time with another company's assets. See ALI Report, pp. 225, 230, 240, 242.

PROPOSED STATUTORY DRAFT OF PURCHASE PRICE RULE FOR LOSS AND CREDIT CARRYOVERS

SEC. 270. LIMITATION ON ALLOWANCE OF NET OPERATING LOSS, CAPITAL LOSS, AND CREDIT CARRYOVERS

(a) General Rule.—In the case of a change in control of a corporation, the amount of—

(1) Net operating loss carryovers;
(2) Net capital loss carryovers which can otherwise be carried forward under section 1212; and
(3) Credit carryovers which can otherwise be carried forward under Part IV of Subchapter A and under section 904(d)

of the corporation (referred to hereafter as the "loss corporation") from a pre-change taxable year to a post-change taxable year shall not exceed an amount equal to the acquisition value of the loss corporation. For purposes of the preceding sentence, the term "pre-change taxable year" means a taxable year of a loss corporation ending before the taxable year in which a change in control occurs. The term "post-change taxable year" means the taxable year of a loss corporation which includes a change in control, and subsequent taxable years.

(b) Change in Control Defined.—

(1) In General.—For purposes of this section, the term "change in control" means—

(A) a purchase of outstanding shares from one or more shareholders, a new issue of shares by the loss corporation in exchange for consideration (including an exchange to which section 351 applies and a recapitalization described in section 368(a)(1)(E)), or a redemption of outstanding stock of a loss corporation, as a result of which any one or more of the shareholders on the last day of the taxable year own a percentage of the total outstanding stock which is 50 percentage points or more in either total fair market value or voting power than the same percentage owned by the same persons at the beginning of that taxable year, or at the beginning of the first or second preceding taxable years; or

(B) a reorganization (within the meaning of section 368(a)(1) other than subparagraph (E) thereof) of a loss corporation, as a result of which the shareholders (immediately before the transaction) of the loss corporation own (immediately after the transaction) less than 50 percent of the total voting power or less than 50 percent of the fair market value of all outstanding stock of the acquiring corporation or of a corporation in control of the acquiring corporation; or

(C) any combination of the transactions described in subparagraphs (A) and (B).

For purposes of this subsection, the term "purchase" means an acquisition of stock the basis of which is determined by reference to its cost to the holder thereof.

(2) Exceptions.—Paragraph (1) shall not apply to changes in control resulting from—

(A) Acquisitions of stock by any person who owns, on the last day of the taxable year, less than 5 percent of the total fair market value of the outstanding stock of the corporation;

(B) Transfers of stock between persons who are each actual or constructive owners of such shares under the rules prescribed by paragraph (3) of subsection (e), or from transfers of stock in connection with a divorce, separation or similar marital event;

(C) Transfers of stock to the extent that the basis thereof is determined under section 1014 (relating to property acquired from a decedent) or section 1015(a) or (b) (relating to property acquired by gift or transfer in trust), or from transfers of stock in satisfaction of a right to receive a pecuniary bequest;

(D) A redemption to pay death taxes to which section 303 applies;

(E) Acquisitions of stock or of an increased percentage interest by a trust which is exempt from tax under section 501(a), or by one or more persons who were full-time employees of the loss corporation continuously during the period of 60 months ending on the last day of the taxable year (or continuously during the period of the corporation's existence, if shorter);

(F) Acquisitions of stock by a creditor of the loss corporation in exchange for a creditor claim against the corporation, but only if the claim was not acquired for a purpose to obtain such stock, and only if the stock is received pursuant to a plan for rehabilitation of a financially troubled business in which holders of a majority of creditor claims by number and amount participate; or

(G) A reorganization which qualifies under section 368(a)(3)(D)(ii).

(c) Acquisition Value Defined.—For purposes of this section, the term "acquisition value" means the unadjusted acquisition value (as defined in paragraph (1)), computed with the modifications described in paragraph (2).

(1) Unadjusted Acquisition Value.—

(A) Purchases, Etc.; Gross-Up.—In the case of a change in control resulting from a transaction referred to in subsection (b)(1)(A), or from any combination of such transactions during any period of 36 consecutive months, "unadjusted acquisition value" shall be determined as follows:

(i) The aggregate price paid by the person or persons who acquire stock of the loss corporation (plus the entire amount paid by the corporation for shares redeemed, if any) will be divided by the sum of the number of shares acquired plus the number of shares redeemed, if any;

(ii) The result in (i) will then be multiplied by the total number of shares actually outstanding after the transaction; and

(iii) From the figure reached under (i) and (ii) there will be deducted the sum of all money or property paid in to the loss corporation in exchange for treasury shares or newly issued shares.

(B) Reorganizations.—In the case of a reorganization referred to in subsection (b)(1)(B) in which stock is received or retained by shareholders of the loss corporation, "unadjusted acquisition value" will be deemed to be equal to the fair market value of such stock plus the amount of money and the fair market value of other property, if any, received by shareholders of the loss corporation.

(2) Modifications.—The unadjusted acquisition value determined under paragraph (1) shall be reduced by:

(A) Cash and cash equivalents.—The amount of cash (plus current receivables and minus current payables) owned by the loss corporation at the date of the change in control; and by

(B) Nonbusiness assets.—The fair market value of—

(i) assets of the kind which produce personal holding company income (as defined in section 543(a)), owned by the loss corporation on the date of the change in control, but without regard to whether or not the cor-

poration is in fact a personal holding company as defined in section 542; and

(ii) business assets acquired within 24 months before the date of the change in control as a contribution to capital or in exchange for stock of the corporation.

Subparagraph (B) shall not apply to the extent the taxpayer establishes to the satisfaction of the Secretary that the property was acquired as an integral part of a bona fide plan to solve serious financial difficulties of the business.

(d) Disposition of Business Assets Following a Change in Control.—

(1) General Rule.—If, within 5 post-change taxable years, a loss corporation (or its successor in a reorganization or liquidation to which section 332 applies), sells or otherwise disposes of any business asset (other than inventory sold in the ordinary course of business) owned by the corporation at the date of the change in control, the entire amount realized will decrease unused acquisition value as of the first day of the taxable year. If such amount exceeds such unused acquisition value, the excess shall be ordinary income to the loss corporation or its successor to the extent of acquisition value absorbed in prior taxable years. Except for section 47 (dealing with recapture of investment credit), no other or additional gain or loss will be recognized to the loss corporation or its successor on a disposition to which this paragraph applies.

(2) Amount Realized.—For purposes of paragraph (1), the amount realized shall be:

(A) In the case of a sale or exchange, the amount of money plus the fair market value of other property received;

(B) In the case of any distribution to shareholders (including redemptions and distributions to which section 301 applies), the fair market value of the business assets distributed.

(3) Exceptions.—

(A) Reorganizations; Section 332.—If substantially all the assets of the loss corporation are transferred to another corporation in a reorganization described in section 368(a)(1) or in a liquidation to which section 332 applies, paragraph (1) shall not apply to the transfer, but will apply to later dispositions by the transferee.

(B) Other nonrecognition transactions.—Paragraph (1) shall not apply to a sale or other disposition in which gain or loss is not recognized in whole or in part.

(C) Purchase of assets in same business.—Paragraph (1) shall not apply if, within 6 months after the date of sale or other disposition, the corporation purchases, for an amount not less than the sale price, other assets for use in the same trade or business as that in which the assets sold or otherwise disposed of were used.

(e) Operating Rules.—

(1) Absorption of Carryovers.—In each post-change taxable year, net operating loss, capital loss, and credit carryovers from pre-change taxable years shall be absorbed, to the extent there is sufficient unused acquisition value, in the sequence elected by the taxpayer or, in the absence of such an election, in the sequence and manner prescribed by regulations adopted by the Secretary. In applying the preceding sentence, capital loss carryovers to a post-change taxable year may offset capital gains in an amount not greater than 5/3 of unused acquisition value, and tax credit carryovers may be utilized in a post-change taxable year in an amount not greater than 1/2 the amount of unused acquisition value.

(2) Unused Acquisition Value.—The term "unused acquisition value" means the excess of acquisition value over—

(A) The amount of net operating loss carryovers to which subsection (a) applies and which has been deducted in prior post-change taxable years;

(B) 3/5 of the amount of capital loss carryovers to which subsection (a) applies and which were used to offset capital gains in prior post-change taxable years; and

(C) Two times the amount of any credit carryovers used in reduction of tax in prior post-change taxable years.

(3) Constructive Ownership.—For purposes of subsection (b), the rules applicable in determining ownership of stock under section 341(d)(1) (relating to collapsible corporations) shall apply in determining changes in control.

(4) Definition of Stock.—For purposes of subsection (b), the term "stock" does not include stock which is:

(A) Not entitled to vote,

(B) Fixed and preferred as to dividends and not entitled to participate in the distribution of earnings in excess of such dividends, and

(C) Not convertible into stock which fails to meet the requirement of (A) or (B).

(f) Special Rules.—For purposes of this section—

(1) Multiple Classes of Stock.—Where more than one class of stock is outstanding, acquisition value will be determined under regulations prescribed by the Secretary, taking into account the relative fair market value, the relative voting power and the relative degree of participation in earnings of each class of outstanding stock.

(2) Stock Acquired for Property; Contributions to Capital.—Where stock of a loss corporation is issued in exchange for property other than money, the price paid by the acquirer will be deemed equal to the fair market value of the property transferred to the corporation. Any transfer of money or other property to a loss corporation as a contribution to capital shall be treated as an exchange of such money or other property for stock of the corporation equal in value to the fair market value of the money or other property transferred.

(3) Series of Transactions.—If a change in control described in subsection (b)(1)(A) is followed, within the succeeding 36 months, by a reorganization to which subsection (b)(1)(B) applies, and to which the person or persons who obtained control are a party, this section shall not apply to the reorganization. If stock acquisitions not resulting in a change in control occur within 36 months before the date of a reorganization to which subsection (b)(1)(B) applies, acquisition value shall be determined by an average price per share under regulations which shall follow the method set forth in subsection (c)(1)(A). Where stock purchases or other stock acquisitions by an acquiring corporation precede, by more than 36 months, a reorganization to which subsection (b)(1)(B) applies, or where nonexchanging shareholders remain after a reorganization described in section 368(a)(1)(B), acquisition value shall be determined by grossing up the consideration issued in the reorganization, under regulations prescribed by the Secretary applying a method similar to the method set forth in subsection (c)(1)(A).

(4) Successive Transactions.—Notwithstanding the provisions of subsection (c), if the limitation under subsection (a) has once been imposed on a carryover, and if another change in control occurs at a later date, the acquisition value arising upon the later change in control shall not exceed the unused acquisition value as of the end of the taxable year immediately preceding the later change in control.

TECHNICAL EXPLANATION OF THE PROPOSAL

The basic idea is to allow loss and credit carryovers to survive a change in stock control of a loss company to the extent the loss company could reasonably have expected to have used its own carryovers if there had been no change in its ownership and control. This result is achieved by allowing the carryovers to survive in reasonable proportion to the present value of the future income stream likely to be produced by business assets of the loss company. As a result, tax attributes will be available to a new owner only as an incident to a transaction in which the acquirer pays primarily for income-producing business assets of the loss company.

General Rules

Net Operating Loss Carryovers. If a corporation having loss carryovers ("loss company") undergoes a change in control of the ownership of its stock, the company (or its successor in the case of a reorganization) will be allowed to deduct net operating loss carryovers up to (and not in excess of) its acquisition value at the time of the transaction.

Capital Loss and Credit Carryovers. Capital loss carryovers following a change in control can offset capital gains the extent of 5/3 of the acquisition value.[1] Tax credit carryovers will survive a change in control in an amount equal to 50 percent of acquisition value.

Basic Definitions

Change in Control. Where a loss company engages in a tax-free reorganization, a change in control occurs if the shareholders of the company (immediately before the transaction) own, immediately afterward, less than 50 percent of the total voting power or of the fair market value of all outstanding stock of the surviving company (including a controlling parent, in the case of a triangular reorganization).

Where shareholders of a loss company sell some or all of their shares in a taxable transaction, or the company issues new shares in exchange for money or property (including a section 351 transaction and a recapitalization under section 368(a)(1)(E)), or the company repurchases some of its outstanding stock, a change in control occurs if five percent or larger shareholders own, on the last day of the taxable year, a percentage of the fair market value or voting power of total outstanding stock which is at least 50 percentage points greater than the same percentage owned by the same persons at the beginning of that year, or at the beginning of the first or second preceding years. Since the rule for purchases and new stock issues is based on an increase in the recipient's percentage point interest, this rule will not count an existing shareholder's "old and cold" stock but will apply only if his existing interest increases by 50 percentage points or more thereafter.

Exceptions. Certain changes in the stock ownership of a loss company are excepted from these limitations. Exceptions are made for:

(a) acquisitions of stock by small (under five percent) shareholders;
(b) gifts of stock or transfers upon death;
(c) transfers of stock between related persons, or in a divorce or marital separation;
(d) stock acquired by key employees, employee stock ownership plans or qualified employee trusts. A key employee is defined as a person employed full time by the company continuously for at least five years;
(e) a redemption of stock to pay estate taxes;
(f) acquisitions of stock by creditors of the company in exchange for their claims. The claim must not have been acquired by the creditor for the purpose of obtaining the stock, and the stock must be received under a plan for rehabilitating a financially troubled business in which holders of a majority of creditor claims, by number and dollar amount of claims, participate. The loss company does not have to be in a formal bankruptcy.
(g) certain reorganizations of financially troubled savings and loan associations.

Changes in the ownership of certain kinds of stock are also excepted. Stock will not be affected by the proposal if it is not entitled to vote, carries fixed and preferred dividend rights (and is not entitled to participate in earnings in excess of those rights), and is not convertible into voting stock or stock which participates in earnings or carries a nonfixed or nonpreferred dividend right.

Acquisition Value. Acquisition value will be determined by reference to the consideration issued in the transaction, and will be subject to certain subtractions.

"Unadjusted" Acquisition Value. Where a single class of stock is outstanding and a change in control results from a purchase of stock from existing shareholders, a new issue of stock by the company, a redemption, or any combination of these transactions during any three consecutive taxable years, the acquisition value of all outstanding stock will be the purchase price paid for the stock which changes hands. (A note, stock, or other property paid as part of the purchase price will be taken into account at fair market value.) If less than all the stock changes hands, the company's total value will be determined by "grossing up" the price paid for the shares which were purchased, newly issued or redeemed. For example, if a new investor buys 5,100 of 10,000 outstanding shares of loss company L for $510,000, the price paid per share is $100 ($510,000 divided by 5,100). This amount ($100) is then multiplied by the total number of outstanding shares after the transaction (10,000) to produce the acquisition value of the loss company, $1 million. If a new investor contributes money or property directly to L in exchange for newly issued shares of L constituting 50 percent or more of L's total outstanding stock, acquisition value will be the value of the company before the infusion of new capital. For example, if L has 10,000 outstanding shares and a new investor contributes $20,000 for 40,000 new shares, the acquisition value of the company is $5,000. This is determined by first computing a price per share to the new investor (50 cents), then multiplying that price by total outstanding shares (50,000) and subtracting the new capital ($20,000). A redemption of outstanding shares reduces, rather than expands, the pool of capital inside a loss company. Accordingly, in a redemption, acquisition value will equal the value of the unredeemed shares immediately after the redemption, based on the per share price paid by the company for the repurchased shares.

Where new stock is issued for property other than money, the value of the stock received will be deemed equal to the fair market value of the property transferred in exchange for the stock. It is immaterial under this rule whether the issuance of new shares is taxable to the transferors or is tax-free under section 351 or under the recapitalization rule of section 368. This rule also applies where a loss company buys profit-generating assets for its own newly issued stock in a transaction taxable to the seller.

Where the stock or assets of a loss company are acquired by another company in a tax-free reorganization, the acquisition value of the loss company will be equal to the fair market value of the stock received by shareholders of the loss company, plus the amount of money and the value of other property, if any.[2]

Where stock purchases or other stock acquisitions precede a tax-free reorganization within three taxable years, acquisition value will be determined by a grossing up a unit price per share under regulations to be prescribed by the Secretary. Where

[1] Ordinarily, a capital loss carryover offsets a capital gain dollar for dollar. However, the tax benefit from a capital loss is 60 percent of the tax benefit from a net operating loss. If the remaining unused acquisition value in the current year, e.g., $800, is less than the unused capital loss carryovers (e.g., $1,000), proper use of capital loss carryovers can be reflected by grossing up the acquisition value by 5/3 to $1,000, with the result that the entire $1,000 capital loss carryover can be deducted in the current year.

[2] If the loss company acquires the profit company, acquisition value will be the value of the combined company's stock retained by shareholders of the loss company. The gross-up calculation for determining acquisition value will be used for this purpose.

stock purchases or other stock acquisitions by the acquirer precede a tax-free reorganization by more than three years (old and cold stock), or where a minority of nonexchanging loss shareholders remains after a "B" type acquisition of less than 100 percent of a loss company's stock, the value of the stock issued in the reorganization will be "grossed up" under similar procedures.

Modifications. Once unadjusted acquisition value is determined, subtractions are required in order to prevent an artificial purchase price or transactions in which assets of a loss company are artificially inflated before a sale takes place. Acquisition value is therefore reduced by:

(a) cash (plus net receivables) owned by the loss company immediately before the transaction;
(b) investment assets (stocks, bonds, real estate, etc.) owned by the loss company at the date of sale; and
(c) business assets transferred into the company within 24 months before the date of sale as a contribution to capital or in exchange for stock.

The subtraction in (b) or (c) will not be made if the taxpayer can show, to the satisfaction of the Secretary, that the property was acquired as part of bona fide effort to rehabilitate an otherwise financially troubled business.

Operating Rules

Absorption of Carryovers. The sequence in which different types of carryovers (net operating loss carryovers, tax credit carryovers and capital loss carryovers) will absorb total acquisition value may be elected by the taxpayer. Once made, this election will be irrevocable unless the Secretary consents to a change in the sequence for prior years. If the taxpayer fails to make an election, the Internal Revenue Service will specify by regulation how different types of carryover will reduce acquisition value. Carryovers to each post-change taxable year will be deductible to the extent sufficient unused acquisition value remains at the end of the immediately preceding year. Unused acquisition value is the original acquisition value, reduced by:

(a) net operating loss carryovers from pre-change taxable years deducted in one or more prior taxable years following the change in control;
(b) 3/5 of the capital loss carryovers from pre-change taxable years used to offset capital gains in one or more prior post-change years; and
(c) two times the amount of any tax credit carryover used to reduce tax in one or more prior post-change years.[3]

Contributions to Capital. A transfer of money or other property directly to a loss company as a contribution to capital will be treated as an exchange of the money or property for stock having a value equal to the amount of money plus the fair market value of the other property.

Series of Transactions. Several rules deal with two-step or multiple step acquisition formats which are often used by one company to acquire another. If a profit company, P, purchases by tender offer 51 percent or more of the stock of a loss company, L, and, within 36 months after the last day of the year in which the final purchase is made, L merges with P, the limitation on carryovers from years before the change in control will be determined solely by reference to the stock purchase price on the first step. The price paid to purchase 50 percent or more of L's stock will be grossed up to determine acquisition value, and the value so determined (with subtractions) will determine the ceiling on carryovers from pre-change taxable years without regard to the merger. If P acquires L's assets by merger more than 36 months after P purchased 51 percent of L's stock, carryovers will be based on the grossed up purchase price in post-purchase taxable years until the merger. Thereafter, carryovers from years before the purchase of control and carryovers, if any, incurred in years after the purchase of control and up to the merger, will be limited by grossing up the fair market value of the stock issued in the merger.

If P purchases 80 percent or more of L's stock and makes an election under section 338, L's carryovers disappear entirely because the election means that the transaction will be treated as a taxable sale and purchase of L's assets (section 338(a)(1)). If P does not make an election in this situation, the purchase price rule will determine how much of L's carryovers survive the change in control.[4]

If P buys less than 50 percent of L's stock and within 36 months merges L with P, acquisition value will be based on a per share purchase price derived from the total consideration paid by P in both steps. If the merger in this situation occurs more than 36 months later, acquisition value will be determined solely by grossing up the fair market value of the stock issued in the merger.

If P buys control of L stock and shortly afterward merges L with S, a controlled subsidiary of P, L's carryovers will be limited to the stock purchase price and no further limitation will be imposed on account of the merger. If the merger fails to qualify as a reorganization and the entire transaction can be recast as a taxable sale of assets by L to S, no carryovers at all may survive. If P purchased L stock long ago, so that its ownership is now "old and cold," and P causes L to merge with S, L's carryovers from before P's purchase will be available to S in the amount of P's original purchase price. The merger will not trigger a new limitation because L's shareholder, P, continued to own more than 50 percent of the stock of the acquiring company, S, after the merger.[5]

Successive Transactions. Where control of a loss company changes through successive new owners, each owner can obtain for the company no more of the carryovers from years before the first change in control than remained to the preceding owner. Thus, if L, a loss company, has $10 million loss carryovers and shareholder A sells all of the stock to new owner B for $1 million, $1 million of the carryovers survive. Assume that $550,000 of those carryovers are used during B's ownership. B then sells all the stock to C. The company could not use more than $450,000 of carryovers remaining under the original limitation, regardless of the amount of C's purchase price. Any losses incurred during B's ownership, however, could carry over to C up to the amount of C's purchase price (after subtracting $450,000 of old, limited carryovers).

Sales of Business Assets Following a Change in Control

If, within five years after a change in control, the loss company or its successor disposes of any business asset (other than inventory sold in the ordinary course of business) owned by the loss company at the time of the change in control, the entire amount realized will decrease acquisition value. If the amount realized exceeds the remaining unused acquisition value, the excess will be ordinary income to the loss company (or its successor) to the extent of acquisition value previously absorbed. Except for investment credit recapture, no other or additional gain or loss will be recognized to the loss company or its successor. If the assets of the loss company or its successors are transferred to another company in a tax-free reorganization or in a section 332 liquidation, the general rule will not apply to the transfer, but will apply to later dispositions by the transferee.

Related Matters

Role of Section 269. The anti-tax avoidance rules of section 269 will not apply to any carryover of net operating losses,

[3] To illustrate with the example in footnote 1, in order to determine the effect of the available capital loss carryover in the current year on acquisition value remaining for future years, acquisition value at the beginning of the current year is reduced by 3/5 of the capital loss carryover used in the current year. Since $1,000 of the capital loss carryover was used in the current year, acquisition value remaining to be absorbed in future years is reduced by 3/5 of $1,000, or $600. Hence, on these facts, no more carryovers of any kind from pre-change years may be deducted.

[4] A complete liquidation of L into P will not reduce the carryovers further, and the remaining amount of acquisition value will be available against P's income, provided the liquidation occurs outside the consistency period of section 338(f).

[5] This more-than-50 percent threshold rule would replace the existing common ownership rule in present section 382(b)(3).

capital losses, or unused tax credits. The statute will be expressly amended to so state.

Spin-offs and Other Corporate Divisions. The Secretary will be given authority to adopt rules for allocating loss and credit carryovers after a corporate division (including a spin-off, split-off or split-up).

Consolidated Returns. If a consolidated return group buys the stock of a loss company, the question arises as to the income of which member of the group the carryover is deductible against (up to the acquisition value of the new member). The question is whether the separate return limitation year rule (SRLY) of Reg. §1.1502-21(c) and the consolidated return change of ownership rule (CRCO) of Reg. §1.1502-21(d) are still needed. These decisions involve consolidated return policy and should be reflected by amendment to the consolidated return regulations.

Chairman RANGEL. Does the solution, in terms of restricting the losses that has been suggested by Mr. Bacon, take care of the——

Mr. TOMASULO. If you deduct the investment assets from your purchase price, in determining the permitted deduction of losses. Whether you want to use an income function or a capital function of the purchase price, that is another question, so much a year, or all at once, and so on, over many years.

But the key question, the basic question, is how much loss are you going to allow when you begin to compute the base for a capital or income function. If you do not deduct the investments, you have returned to pure nonsense. You have returned to Alprosa Watch.

The bill that came out Friday in the Senate, Alprosa Watch would walk right through that case, because there is no sanction against selling the assets after the transfer; that is there is no anti-Alprosa provision. In the bill only one-third business assets are required. It is one-third common sense. I favor three-thirds common sense. The bill would be incredibly worse than present law because it does not provide for the deduction of investments and for the deduction of the sale price of business assets sold after the stock transfer.

Chairman RANGEL. Thank you.

Mr. Ellingson.

STATEMENT OF JOHN F. ELLINGSON, ESQ., BELLEVUE, WA

Mr. ELLINGSON. Mr. Chairman, members of the committee, I am a lawyer practicing in Bellevue, WA, a suburb of Seattle.

During 1979 and 1980 I chaired an American Bar Association Young Lawyers Division Subcommittee on Tax Treatment of Bankruptcy, and worked with Mr. Bacon when he was on the Joint Committee on the Bankruptcy Tax Act of 1980, and have worked with both Mr. Bacon and Mr. Tomasulo since.

My position here today—I am speaking solely for myself—to point out that all the proposals that have been made, both the ALI/ABA proposal and Treasury's offshoot of that, and Mr. Bacon's proposal, while they work fine for solvent companies, the logic fails when you deal with an insolvent company coming out of a bankruptcy chapter proceeding.

The possibility for abuse with a bankrupt company is minimal possibility, since the company that is rehabilitated in a chapter 11 proceeding is rehabilitated under the supervision of the court. The Internal Revenue Service is typically a creditor with a voice in that proceeding. The proceeding is primarily an adversarial one. There is close examination of the affairs of the taxpayer during the reorganization, and the possibility of abuse is greatly diminished, if not totally eliminated.

As I am sure this committee is aware, bankruptcy has been a growth industry in the United States in recent years. Even during the recent upturn in the economic economy, in the western district of Washington, the number of bankruptcy filings increased by approximately 10 percent. The statistics in that district show that since October 1979, and the passage of the new Bankruptcy Code, through December of 1984 only 10 percent of those corporations filing chapter 11 plans, have those plans confirmed by the court.

Insolvency proceedings represent a fairly small number of corporations, although they represent, across the country, a significant portion of the economic wealth and production capacity of the country.

The stated policy in the Bankruptcy Code, and the Bankruptcy Tax Act of 1980, was to facilitate the reorganization of these insolvent companies. To impose upon companies coming from a negative position, the sort of limitations on NOL carryovers that have been proposed, treats them worse than it would treat a solvent taxpayer.

There is a built-in bias against the insolvent taxpayer in the current proposals and that sort of bias is contrary to the stated policy of the Bankruptcy Code and the Bankruptcy Tax Act of 1980.

What I would propose, and what I proposed in my written testimony, is an exception for the application of any rule that comes out of these proceedings for insolvent companies in chapter proceedings, but only to the extent of their insolvency. Once you make that adjustment, insolvent taxpayers should be treated as you would any solvent corporate taxpayers. And whatever rule is adopted should be applied them, as to any other taxpayer.

I propose that the insolvency amount referenced or the written submission be determined on a fair market value basis, based on the documents filed with the bankruptcy court. These documents are filed under penalty of perjury, copies of those forms are attached to the written submission.

Thank you.

[The prepared statement follows:]

MEMORANDUM

Date: May 22, 1985.

Re Proposal for an Exception to the Application of IRC Section 382(b) to Insolvent Corporate Taxpayers.

To: Committee on Ways and Means.

From: John F. Ellingson.

This proposal is to apply Section 382(b) in a manner consistent with prior tax policy as expressed in former Section 371 et seq. and the rehabilitation policy of the Bankruptcy Code, 11 USC Sections 101 et seq.

The proposal is to except a corporate taxpayer under the jurisdiction of the court in a Title II or similar case from the application of Section 382 (in whatever form new limitations are adopted) from a transaction to which it would otherwise apply. The exception would apply only to the extent of the insolvency of the taxpayer, as determined on the date of the filing of the petition in bankruptcy. The application of Section 108(b) would not be altered by the above exception.

The intent is to allow an insolvent taxpayer in Title 11 case to retain as much of its existing tax history (as is otherwise available) to apply against earned income during recovery. It is not the intent to shelter this income from taxation if the insolvent taxpayer does not otherwise have sufficient loss carryovers. This is in no sense an attempt to create a subsidy for insolvent taxpayers.

The test to measure the degree of insolvency would be a fair market value test reflecting the taxpayer's financial condition on the date of filing its petition in bankruptcy, subject to adjustments for income earned and other deductions generat-

ed during the administration of the estate. It is the intent of this proposal to allow the insolvent taxpayer to earn income and protect existing tax history in a sufficient amount to redeem any stock issued to creditors to cure an insolvent condition.

First Example: The facts concerning the debtor company are as follows:

	In millions
Assets at fair market value	$10
Liabilities	$40
(Long term bank debt	$20)
(Short term trade debt	$20)
NOL carryforward	$40

In recapitalization, $10 MM of bank debt remains outstanding; new stock is issued to the bank for the remaining $10 MM of its claim; all corporate assets remain with the taxpayer as essential to the taxpayer's business; and nothing is paid to the trade creditors; resulting in a discharge of their claims. In applying the proposal to this situation, the following results would occur: Based on the fair market value of the assets, the debtor company is insolvent to the extent of $30 MM and this amount is excepted from the application of Section 382 (but not from application of Section 108(b)). The $40 million NOL is reduced by $20 million by reason of the discharge of trade debt (Section 108(b)). Therefore, only $10 million of the carryover remains subject to the exception, $30 million insolvency amount less $20 million reduction under Section 108(b). Issuance of new stock to the bank for $10 million of its claim does not reduce the carryover under Section 108(b) because of the "stock for debt rule".

In the example, protection of $10 million of the NOL would allow the reorganized company to utilize part of its otherwise available carryover against future income sufficient to redeem the stock issued to the bank.

Second Example:

	In millions
Assets at fair market value	$11
Liabilities	$14
NOL carryforward	$25
	$11
	−$14
Insolvency amount	$3
New Investor Capital	$11

To apply the insolvency exception to this situation:

1. Insolvency exception shelters $3 MM of the NOL carryforward;

2. $3 MM of carryover would be unadjusted by Section 382 because of the insolvency exception; and

3. $22 MM of the NOL would be subject to Section 382 adjustment.

This exception would apply only to corporations, in Chapter 11. It is not the intent to give a formerly insolvent company any advantages under section 382 over other taxpayers once solvency is achieved. This exception would apply equally to financial restructuring or exchanges involving creditors or third party investors.

This exception might be applied to insolvent corporations outside of Title 11 if the taxpayer would meet the same proof standard required of a taxpayer under Title 11.

In a Title 11 case, the debtor is required to file with the court a statement of its financial affairs (exhibits attached), which provides statement of the fair market value of the taxpayer's assets and its liabilities. This statement, made under oath, is subject to scrutiny and adjustment by the court to deal with claims of creditors, action by a trustee on the debtor in possession. The IRS is typically a creditor with notice of the proceeding and well able to argue the values of assets or creditor's claims during the pendency of the case.

While it could be argued that determining the degree of insolvency involves a degree of uncertainty, the court, creditors and the debtor, as well as the parties to the exchange in their negotiations and implementation of the reorganization will, from a practical point of view, provide sufficient scrutiny to assure that the stated values of the assets are as accurate as can be determined. It should not be considered a great burden to the taxpayer seeking the protection of the exception to carry the burden of proof of presenting these documents which should be presumptive of the degree of insolvency. It might be desirable for the regulations issued under this proposal to require such a representation by a taxpayer seeking this protection to be filed in a manner similar to the filing requirements currently in force for Section 368 transactions.

There is currently under discussion among practitioners and The Senate Finance Committee a provision that would take into account the effect of a stock for debt swap that is part of a reorganization of a debtor corporation. This proposal would disallow interest deductions for interest paid to a creditor that exchanged that creditor position for stock of the debtor company. The current proposal would disallow the interest for a period of three years prior to the effective date of the reorganization.

While I endorse the concept of recognizing the effect of the stock for debt exchange, I feel that an arbitrary application of any rule is a disservice to all who deal with it. I propose a rule that would utilize the three year period of disallowing the interest deduction, but would make the presumption of the three year period rebuttable. If a taxpayer could show by credible evidence some other point in time at which insolvency occurred, that period would be the operative period.

Respectfully submitted.

JOHN F. ELLINGSON.

United States Bankruptcy Court

for the _____ District of _____, Division _____

In re

Case No._____

Soc. Sec. No. _____

Debtor (include here all names used by debtor within last 6 years)

STATEMENT OF FINANCIAL AFFAIRS FOR DEBTOR ENGAGED IN BUSINESS

(Each question should be answered for, or the failure to answer explained. If the answer is "none", this should be stated. If additional space is needed for the answer to any question, a separate sheet properly identified and made a part hereof, should be used and attached.

If the debtor is a partnership or a corporation, the questions shall be deemed to be addressed to, and shall be answered on behalf of, the partnership or corporation; and the statement shall be certified by a member of the partnership or by a duly authorized officer of the corporation.

The term, "original petition", as used in the following questions, shall mean the petition filed under Rule 13-103, or Rule 3-104 if applicable.

1. Nature, Location, and Name of Business.

a. Under what name and where do you carry on your business?

b. In what business are you engaged? *(If business operations have been terminated, give the date of such termination.)*

c. When did you commence such business?

d. Where else, and under what other names, have you carried on business within the 6 years immediately preceding the filing of the original petition herein? *(Give street addresses, the names of any partners, joint adventures, or other associates, the nature of the business, and the periods for which it was carried on.)*

e. What is your employer identification number?
Your social security number?

2. Books and Records.

a. By whom, or under whose supervision, have your books of account and records been kept during the 2 years immediately preceding the filing of the original petition herein? *(Give names, addresses, and periods of time.)*

Debtor _____ Case No. _____

b. By whom have your books of account and records been audited during the 2 years immediately preceding the filing of the original petition herein?
(Give names, addresses and dates of audits.)

c. In whose possession are your books of account and records?
(Give names and addresses.)

d. If any of these books or records are not available, explain.

e. Have any books of account or records relating to your affairs been destroyed, lost, or otherwise disposed of within the 2 years immediately preceding the filing of the original petition herein?
(If so, give particulars, including date of destruction, loss, or disposition, and reason therefor.)

3. **Financial Statements.**

Have you issued any written financial statements within the 2 years immediately preceding the filing of the original petition herein?
(Give dates, and the names and addresses of the persons to whom issued, including mercantile and trade agencies.)

4. **Inventories.**

a. When was the last inventory of your property taken?

b. By whom, or under whose supervision, was this inventory taken?

c. What was the amount, in dollars, of the inventory?
(State whether the inventory was taken at cost, market or otherwise.)

d. When was the next prior inventory of your property taken?

e. By whom, or under whose supervision, was this inventory taken?

f. What was the amount, in dollars, of the inventory?
(State whether the inventory was taken at cost, market, or otherwise.)

g. In whose possession are the records of the 2 inventories above referred to?
(Give names and addresses.)

5. **Income Other Than From Operation of Business**

What amount of income, other than from operation of your business, have you received during each of the 2 years immediately preceding the filing of the original petition herein?
(Give particulars, including each source, and the amount received therefrom.)

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6. Tax Returns and Refunds.

a. In whose possession are copies of your federal and state income tax returns for the 3 years immediately preceding the filing of the original petition herein?

b. What tax refunds (income or other), have you received during the 2 years immediately preceding the filing of the original petition herein?

c. What tax refunds (income or other), if any, are you, or may you be, entitled?
(Give particulars, including information as to any refund payable jointly, to you and your spouse or any other person.)

7. Bank Accounts and Safe Deposit Boxes.

a. What bank accounts have you maintained alone or together with any other person, and in your own or any other name, within the 2 years immediately preceding the filing of the original petition herein?
(Give the name and address of each bank, the name in which the deposit was maintained, and the name and address of every person authorized to make withdrawals from such account.)

b. What safe deposit box or boxes or other depository or depositories have you kept or used for your securities, cash, or other valuables within the 2 years immediately preceding the filing of the original petition herein?
(Give the name and address of the bank or other depository, the name in which each box or other depository was kept, and name and address of every person who had the right of access thereto, a description of the contents thereof, and, if the box has been surrendered, state when surrendered, or, if transferred, when transferred and the name and address of the person.

8. Property Held For Another Person.

What property do you hold for any other person?
(Give name and address of each person, and describe the property, the amount of value thereof and all writings relating thereto.)

9. Prior Bankruptcy Proceedings.

What cases under the Bankruptcy Act or Title 11, United States Code, have previously been brought by or against you?
(State the location of the bankruptcy court, the nature and number of the case, and whether a discharge was granted or refused, the case was dismissed, or a composition, arrangement, or plan was confirmed.)

Debtor _____ Case No. _____

10. Receiverships, General Assignments and Other Modes of Liquidation.

a. Was any of your property, at the time of the filing of the original petition herein, in the hands of a receiver, trustee, or other liquidating agent?
(If so, give a brief description of the property and the name and address of the receiver, trustee, or other agent, and, if the agent was appointed in a court proceeding, the name and location of the court, the title and number of the case; and the nature thereof.)

b. Have you made any assignment of your property for the benefit of your creditors, or any general settlement with your creditors, within the 2 years immediately preceding the filing of the original petition herein?
(If so, give dates, the name and address of the assignee, and a brief statement of the terms of assignment or settlement.)

11. Property in Hands of Third Person.

Is any other person holding anything of value in which you have an interest?
(Give name and address, location and description of the property, and circumstances of the holding.)

12. Suits, Executions, and Attachments.

a. Were you a party to any suit pending at the time of the filing of the original petition herein?
(If so, give the name and location of the court and the title and nature of the proceeding.)

b. Were you a party to any suit terminated within the year immediately preceding the filing of the original petition herein?
(If so, give the name and location of the court, the title and nature of the proceeding, and the result.)

c. Has any of your property been attached, garnished, or seized under any legal or equitable process within the year immediately preceding the filing of the original petition herein?
(If so, describe the property seized or person garnished, and at whose suit.)

13. Payments on Loans and Installment Purchases.

What repayments on loans in whole or in part, and what payments on installment purchases of goods and services, have you made during the year immediately preceding the filing of the original petition herein?
(Give the names and addresses of the persons receiving payment, the amounts of the loans and of the purchase price of goods and services, the dates of the original transactions, the amounts and dates of payments, and, if any of the payees are your relatives or insiders, the relationship: If the debtor is a partnership and any of the payees is or was a partner or a relative of a partner, state the relationship: If the debtor is a corporation and any of the payees is or was an officer, director, or stockholder, or a relative of an officer, director or stockholder, state the relationship.

Debtor _____ Case No. _____

14. Transfer of Property.

a. Have you made any gifts, other than ordinary and usual presents to family members and charitable donations, during the year immediately preceding the filing of the original petition herein?
(If so, give names and addresses of donees and dates, description, and value of gifts.)

b. Have you made any other transfer, absolute or for the purpose of security, or any other disposition which was not in the ordinary course of business during the year immediately preceding the filing of the original petition herein?
(Give a description of the property, the date of the transfer or disposition, to whom transferred or how disposed of, and state whether the transferee is a relative, partner, shareholder, officer, director or insider, the consideration, if any, received for the property, and the disposition of such consideration.)

15. Accounts and Other Receivables.

Have you assigned, either absolutely or as security, any of your accounts or other receivables, during the year immediately preceding the filing of the original petition herein?
(If so, give names and addresses of assignees.)

16. Repossessions and Returns.

Has any property been returned to, or repossessed by, the seller or by a secured party during the year immediately preceding the filing of the original petition herein?
(If so, give particulars, including the name and address of the party getting the property and its description and value.)

17. Business Leases.

If you are a tenant of business property, what is the name and address of your landlord, the amount of your rental, the date to which rent had been paid at the time of filing of the original petition herein, and the amount of security held by the landlord.?

18. Losses.

a. Have you suffered any losses from fire, theft, or gambling during the year immediately preceding the filing of the original petition herein?
(If so, give particulars, including dates, names, and places, and the amounts of money or value and general description of property lost.

b. Was the loss covered in whole or part by insurance?
(If so, give particulars.)

Debtor _____ Case No. _____

19. Withdrawals.

a. If you are an individual partner of your business, what personal withdrawals of any kind have you made from the business during the year immediately preceding the filing of the original petition herein?

b. If the debtor is a partnership or corporation, what withdrawals, in any form (including compensation, bonuses or loans), have been made or received by any member of the partnership, or by any officer, director, insider, managing executive, or shareholder of the corporation, during the year immediately preceding the filing of the original petition herein?
(Give the name and designation or relationship to the debtor of each person, the dates and amounts of withdrawals, and the nature or purpose thereof.)

20. Payments or Transfers to Attorneys.

a. Have you consulted an attorney during the year immediately preceding or since the filing of the original petition herein?
(Give date, name and address.)

b. Have you during the year immediately preceding or since the filing of the original petition herein paid any money or transferred any property to the attorney, or to any other person on his behalf?
(If so, give particulars, including amount paid or value of property transferred and date of payments or transfer.)

c. Have you, either during the year immediately preceding or since the filing of the original petition herein, agreed to pay any money or transfer any property to an attorney at law, or to any other person of his behalf?
(If so, give particulars, including amount and terms of obligations.)

(If the debtor is a partnership or corporation, the following additional questions should be answered.)

21. Members of Partnership, Officers, Directors, Managers, and Principal Stockholders of Corporation.

a. What is the name and address of each member of the partnership, or the name, title, and address of each officer, director, insider, and managing executive, and of each stockholder holding 20 per cent or more of the issued and outstanding stock, of the corporation?

b. During the year immediately preceding the filing of the original petition herein, has any member withdrawn from the partnership, or any officer, director, insider, or managing executive of the corporation terminated his relationship, or any stockholder holding 20 per cent or more of the issued stock disposed of more than 50 per cent of his holdings?
(If so, give name and address and reason for withdrawal, termination, or disposition, if known.)

c. Has any person acquired or disposed of 20 per cent or more of the stock of the corporation during the year immediately preceding the filing of the petition?
(If so, give name and address and particulars.)

United States Bankruptcy Court

for the _____ District of _____ Division _____

In re

Soc. Sec. No. _____,
Debtor, *(include here all names used by debtor within last 6 years)*

Case No. _____

CERTIFICATION OF

_____

Each of the undersigned certifies under penalty of perjury that the foregoing _____
_____
consisting of _____ pages, are authorized and ture and correct to the best of my knowledge, information and belief.

Dated: _____ Signed: _____

(Persons certifying for partnership or corporation should indicate position or relationship to debtor). _____

_____

Certification of _____
Washington Legal Blank Inc., Bellevue, WA 11/82
MATERIAL MAY NOT BE REPRODUCED IN WHOLE OR IN PART IN ANY FORM WHATSOEVER.

Chairman RANGEL. Did you two think about that?

Mr. BACON. I think that is a meritorious exception.

Mr. TOMASULO. I have not worked on it.

Chairman RANGEL. You do that. Would you take a look at the problem of insolvent companies for us?

Mr. TOMASULO. Yes.

Mr. ELLINGSON. I believe it is the intent of the Congress, and the intent of the Treasury, to rehabilitate these companies. To create this proposed exception probably is revenue positive. If an insolvent company disappears, there is no revenue to be gained from the company, whether it has losses, or does not have losses. The company disappears as a taxpayer, as well.

If the company is kept alive, and is able to utilize its losses, even if that corporate taxpayer pays no taxes directly, it does pay taxes on the wages it pays. If it pays any dividends going forward, those are taxed to the shareholders, and further, it prevents any expenditures in the way of entitlement programs for the workers that would be put out of work by the failure of the company.

So I think the net result of providing an exception for companies coming out of a chapter 11 is revenue positive.

Mr. BACON. One other statement to supplement that. In addition to Mr. Ellingson's suggestion for bankrupt companies, you are going to be receiving, I believe, some correspondence from the Federal Home Loan Bank Board, which supervises mergers of failing savings and loan associations around the country. That has been an important area. There is a special rule in the existing tax law to preserve losses where this Government agency has to step in and merge a failed institution with another. For the same reason Mr. Ellingson suggested we deal with bankrupt companies, we should provide the same treatment for the savings and loans that are analogous to bankruptcy cases, but are reorganized under special provisions of the National Housing Act.

Chairman RANGEL. Well, you join Mr. Tomasulo, in thinking of other equitable, positive exceptions.

Mr. TOMASULO. Thrift institutions and banks are in a different—in my prepared statement, I say I do not think the statute should apply to any thrift institution that continues as a thrift institution, or bank that continues as bank, because obviously, those are not manipulative transactions. They are rescuing the depositors' transactions. That is only common sense.

Chairman RANGEL. Dr. LaRue, or Professor LaRue.

STATEMENT OF DAVID W. LaRUE, PH.D., ASSISTANT PROFESSOR, THE McINTIRE SCHOOL OF COMMERCE, UNIVERSITY OF VIRGINIA

Mr. LARUE. Mr. Chairman, members of the committee, I am an assistant professor of taxation at the McIntire School of Commerce at the University of Virginia. My conclusions and analyses today are part of a comprehensive and systematic inquiry into the rules and regulations governing the Federal income taxation of corporate acquisitions. This research is being conducted by myself and two of my colleagues at the University of Virginia, Joe Gibson and David Maloney, and is being funded by Arthur Young & Co. Foundation.

I am not, however, representing Arthur Young, or any other organization, and my comments do not necessarily reflect the opinions of Arthur Young.

My comments today concern the propriety of denying the carryback of postacquisition net operating losses, capital losses and similar tax benefits to offset the preacquisition taxable income of the acquired corporation(s) following certain classes of nontaxable corporate asset acquisitions.

Unfortunately, the statute is not as generous in its allowance of carrybacks of favorable postacquisition tax attributes as it is in permitting carryforwards of premerger attributes. Section 381(b)(3) provides that except in the case of a type F reorganization, the postacquisition tax attributes generated by the business of an acquired corporation may not be carried back to offset the taxable income that that same business reported on its tax returns for its premerger tax years.

The legislative history of section 381(b)(3) indicates the sole objective in denying carrybacks in nontaxable acquisitions was that Congress did not want the transferee corporation to be allowed to carryback the postmerger losses of its premerger business to offset the premerger taxable income of the transferor corporation or corporations. Stated differently, they did not want a transferor, that is, the acquiring corporation, to be able to use its postacquisition losses to offset the taxable income that was actually paid by one of the acquiring corporations, and thereby generate a refund.

Over the years several defects in the statutory design of the reorganization provisions have emerged. One frequently cited criticism is that transactions which are equivalent, or very nearly equivalent in terms of their economic effect, but which differ slightly in terms of the technical form through which those transactions are ultimately accomplished, may produce markedly different tax results.

More specifically, the limitations under section 381(b)(3), and a companion section, section 368(a)(1)(F), the type F reorganization, are inconsistent provisions governing carrybacks following other, economic equivalent, transactions.

Further, I am of the opinion that these rules are unduly restrictive insofar as tax avoidance prevention is a legitimate concern. They are economically unsound, and they fail to conform to accepted standards of equity. These problems derive from the fact that section 381(b)(3) denies the carryback of postacquisition net operating losses and other tax attributes unless the transaction qualifies as a type F reorganization, and that the type F reorganization is, in turn, limited to amalgamations or consolidations of but one operating corporation. Prior to 1982, the Service and the courts had generally accepted the application of the type F reorganization to mergers and consolidations involving multiple commonly owned operating corporations.

Another facet of the problem as I see it is that type F reorganizations have generally been judicially restricted to transactions which involve no shift in proprietary interest.

Three years ago the statutory definition of a type F reorganization was modified to limit the type F reorganization, and hence the application of section 381(b)(3), to transactions involving only one

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operating corporation. This was done in order to restore the type F reorganization to what was perceived to be its historical role.

In my opinion, these amendments should be revoked. First, the interpretation of the original purpose and intent behind section 368(a)(1)(F) which gave rise to the change 3 years ago, is incorrect. I have about 30 pages in my prepared statement which support my contention that the legislative history of the type F reorganization was misread 3 years ago when the change was made to restrict its application to just one operating corporation.

Second, from the policy standpoint, the denial of the type F reorganization status to transactions involving more than one operating corporation is incongruent with accepted tenets of Federal taxation, such as horizontal equity and the notion that substance should prevail over form in assessing tax consequences.

Briefly, one other comment I have regarding the reinstitution of the old type F reorganization, is that there do not appear to be any tax avoidance problems insofar as applying the type F reorganization to mergers and multiple operating corporations. There are between 20 and 30 decisions that were decided prior to TEFRA in which the courts allowed mergers of multiple operating corporations to qualify as type F reorganizations.

In none of those cases did the judge or given government suggest that the taxpayer was obtaining improper tax savings, or that there was otherwise any tax avoidance motive behind the transaction.

I would also like to suggest that this committee consider the merits of extending the carryback privilege to acquisitions which involve shifts in proprietary interests. In this regard, let me refer you to the decisions and supporting rationale of the Second Circuit Court of Appeals in *Aetna Casualty & Surety* and the Ninth Circuit Court of Appeals in *Bercy Industries*, both of which are discussed and analyzed in my written statement.

In one of these cases, the courts were concerned with the inequity, or rather, the lack of consistency or symmetry between the allowance of carrybacks in nontaxable stock acquisitions compared with the allowance of carrybacks in nontaxable asset acquisitions.

In conclusion, I believe that the carryback privilege should be extended to all nondivisive reorganization forms, subject to two limitations. First, the standards set forth in sections 382 and 269, whatever those may turn out to be, and second, the Stauffer or the Revenue Ruling 75–561, business entity tracing rule.

Ladies and gentlemen, thank you for your time today.

[The prepared statement follows:]

STATEMENT OF DAVID W. LARUE, PH.D., ASSISTANT PROFESSOR OF THE MCINTIRE SCHOOL OF COMMERCE, UNIVERSITY OF VIRGINIA

INTRODUCTION

My name is David W. LaRue. I am an Assistant Professor of Taxation at the McIntire School of Commerce at the University of Virginia, and I am presenting this testimony both as an interested taxpayer and as one who is knowledgable in the field of corporate taxation. My conclusions and analyses are part of a comprehensive and systematic inquiry into the laws, regulations, and precedents which today govern the federal income taxation of corporate acquisitions. This research is being conducted by myself and two of my colleagues at the University of Virginia, Joseph Gibson and David Maloney, and is being funded by the Arthur Young and Company Foundation. I am not, however, representing Arthur Young or any other organization, and my comments do not necessarily reflect the position of Arthur Young.

My comments today concern the propriety of denying the carryback of post-acquisition net operating losses, capital losses, and similar tax benefits to offset the pre-acquisition taxable income of the acquired corporation(s) following certain classes of nontaxable corporate asset acquisitions. Given the complexity of the issues and the limited amount of time available to summarize, I will confine my oral comments to identifying the nature of the problem and to presenting my recommendations.

CARRYBACKS OF POST-ACQUISITION NET OPERATING LOSSES: SECTION 381(b)(3)

When the assets of one corporation are acquired by another in certain nontaxable transactions, Section 381(a) requires " . . . the acquiring corporation (to) succeed to and take into account of . . . the (accumulated tax attributes) of the distributor or transferor corporation . . . ." This general rule is subject to a host of limitations and refinements.

Unfortunately, the statute is not as generous in its allowance of carrybacks of favorable post-acquisition tax attributes as it is in permitting carryforwards of pre-merger attributes. Section 381(b)(3) provides that except in the case of a Type F reorganization,

> The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

The legislative history of Section 381(b)(3) leaves little doubt that Congress' sole purpose in denying carrybacks in nontaxable asset acquisitions was that it did not want the transferee corporation to be allowed to carry back the post-merger losses of its pre-merger business to offset the pre-merger taxable income of the transferor corporation or corporations, and

that it perceived the complexity of the accounting problems which would otherwise result in carrying out this restriction to be so overwhelming as to necessitate the prohibition.

> Section 381(c)(1) makes no provision for the carryback of net operating losses where there has been a merger or other reorganization. Some limitation upon carrybacks in reorganizations and mergers is justifiable on the ground that it is too complex in some cases to determine to which of several component corporations the loss of the surviving corporation is attributable.[1]

SHORTCOMMINGS OF THE PRESENT STATUTE

The tax consequences flowing from corporate reorganizations are generally made to depend upon compliance or noncompliance with precise technical specifications which are set forth in the statutory provisions governing such transactions. Given the nontax complexity which typifies these classes of transactions; given the virtually unlimited number of ways in which such transactions may be structured; given the lack of a consistent theoretical framework within which the statutory tax rules were originally constructed and have since been refined; and given the inherent limitations upon the draftman's ability to forsee and resolve problems resulting from the preceeding, it is not suprising to find that this body of tax law is, and has always been, replete with imperfection. One frequently-cited criticism is that transactions which are equivalent or near-equivalent in terms of their economic effect, but which differ slightly in terms of the technical form through which each is ultimately accomplished, may be productive of drastically disparate tax consequences. This persistent flaw in the statutory construction has been greatly compounded by both the Service and the courts through their uneven application of the often-recited tenet that where substance and form differ, the former should prevail over the latter in assessing tax consequences.

More specifically, the current limitations governing the carryback of post-merger tax attributes to offset the pre-merger income of one or more acquired corporations are inconsistent with provisions governing carrybacks in other, economically equivalent transactions. Further, these rules are unduly restrictive insofar as tax avoidance prevention is a legitimate concern, are economically unsound, and fail to conform to accepted standards of tax equity. These problems derive from the fact that the prohibition set forth in Section 381(b)(3) is mitigated only with respect to one class of corporate reorganization, the Type F reorganization, and that the Type F reorganization is, in turn, defined so as to exclude (1) mergers and consolidations of two or more commonly-owned operating corporations, and (2) transactions which result in a shift in the proprietary interests of the corporation.[2]

EXTENSION OF THE CARRYBACK PRIVILEGE TO ACQUISITIONS INVOLVING MULTIPLE OPERATING CORPORATIONS

Nature of the Problem

The essential nature of the first of two fundamental flaws in Section 381(b)(3) is demonstrated in the following scenerio. On 12/31/84, X Corporation, a calendar year taxpayer, merged into Y Corporation, also a calendar year taxpayer, in a transaction which qualified as a nontaxable Type A reorganization. After the merger, the business of each was maintained as a separate division in Y Corporation. For each of the three years preceeding the merger (1982-1984), X Corporation reported $100,000 of taxable income, while Y Corporation reported $150,000 in each of these three years. Due to unanticipated business reversals in 1985, Y Corporation suffered a $700,000 net operating loss, $300,000 of which is attributable to the business formerly conducted by X Corporation.

Had there been no merger, X Corporation would have been entitled to utilize its $300,000 1985 loss fully against its 1982-1984 taxable income, and Y Corporation would likewise have used its $400,000 loss to offset all of its 1982 and 1983 income and $100,000 of its 1984 income. Due to the intervening merger, however, Section 381(b)(3) comes into play, and, in all but a Type F reorganization, requires a less favorable outcome. The 1985 losses may be carried back to Y Corportion's pre-merger income but may not be used to offset any amount of X Corporation's pre-merger income. Instead of carrying back the full $700,000 net operating loss with tax benefit, Y Corporation may carryback only $450,000.[3] The $250,000 balance may be carried forward for up to 15 years. Y Corporation must thus wait until a future year to obtain any economic benefit from the loss, and will lose all such benefit should it fails to generate sufficient income during the carryover period (or, assuming the worst, prior to the termination of its business activities). Had X Corportion and Y Corporation combined via consolidation rather than through merger, both would have been "transferor corporations" and none of the 1985 loss could have been carried back.

If, on the other hand, the merger could somehow be interpreted as constituting a Type F reorganization, Section 381(b)(3) would be inapplicable, and the full $700,000 1985 loss could be carried back just as though the combination had never taken place at all.

Overview of the Pre-1982 Historical Development Of the Type F Reorganization

Prior to the Fifth Circuit's 1966 decision in Davant v. Comm.,[4] there was an absolute dearth of authority for the notion that mergers or consolidations involving two or more operating corporations, even when owned in identical proportions by the same shareholders, could be the "mere change" in "identity" or "form" required under Section 368(a)(1)(F). Following the

government's lead in several so-called "liquidation-reincorporation" cases,[5] however, taxpayers seeking the benefits of Section 381(b) asserted that mergers of commonly-owned operating corporations could qualify as Type F reorganizations. As fate would have it, the taxpayers use of the Type F reorganization as an ally coincided with the Service's realization that even the now-expanded Type F reorganization, for which it had labored so ardently, contributed little if anything to its anti-reincorporation campaign. The Type D reorganization, throughout the same period which witnessed the rise of the Type F reorganization, had proven to be a much stronger weapon in this regard than the government had initially been anticipated. By 1967, it was apparent that a reincorporation transaction which qualified as a Type F reorganization invariably also qualified as a Type D reorganization. Conversely, reincorporations which failed to meet the rigors of the Type D reorganization, had consistently been rejected by the court as Type F reorganizations. Thus, the Type F reorganization added nothing to that which already was provided for in the Type D reorganization.

Recognizing, perhaps, that it had more to lose from taxpayers' use of an expanded Type F reorganization interpretation in seeking carrybacks of post-merger tax benefits than it had to gain from such an interpretation in defending the revenues against reincorporation transactions, the government abruptly initiated a 180 degree course correction. From 1967 to late in 1975, it aggressively, but unsuccessfully, opposed the application of the Type F reorganization in several cases involving mergers and consolidations of two or more commonly-owned operating corporations.[6]

In 1975, the government conceded the issue. Revenue Ruling 75-561,[7] set forth three requirements which would have to be met in order for a merger or consolidation of multiple operating corporations to qualify as Type F reorganizations:

1. There must be complete identity of shareholders and their proprietary interests in the transferor corporations and acquiring corporations. In the case of wholly-owned subsidiary-into-parent merger, this requirement will be deemed to be satisfied when the shareholders and their proprietary interests in the parent do not change as a result of the merger;[8]

2. The transferor corporation(s) and the acquiring corporation must be engaged in the same business activities or integrated activies before the combination; and

3. The business enterprise of the transferor corporations and the acquiring corporation must continue unchanged after the combination.

In order to carryback net operating losses, investment tax credits, etc., two additional requirements would have to be satisfied:

1. It must be able to show that the losses are attributable to a separate business unit or division formerly operated by the transferor corporations; and,

2. The transferor corporation must have income in its pre-reorganization taxable years against which such losses can be offset.

Such carrybacks were to be subject to the limitations of the "but for" rationale adopted by the Ninth Circuit Court of Appeals in Stauffer v. Comm.[9] Notwithstanding the government's repeated claims that multi-corporate Type F reorganizations would render the statute patently "unworkable," the ruling neither identifies these purportedly numerous problem areas, nor suggests the manner in which they might be resolved.

In Revenue Ruling 78-287,[10] the Service expanded this ruling to encompass "downstream mergers" of a parent corporation into its wholly-owned subsidiary providing that the other requirements of Revenue Ruling 75-561 had been satisfied. Revenue Ruling 78-441,[11] on the other hand, softened the complete proprietary identity requirement to allow for di minimus (less than one percent) changes in interest.

The Tax Equity and Fiscal Responsibility Act of 1982

The New Type F Reorganization Definition

The Tax Equity and Fiscal Responsibility Act of 1982 did not eliminate the Type F reorganization as an exception to the operational rules of Section 381(b). Instead, it limited Section 368(a)(1)(F) to transactions involving but one operating corporation. Section 225(a) of the Act modified the definition of Section 368(a)(1)(F) to read "mere changes in the identity, form, of place of organization of one corporation, however effected." (Emphasis supplied.) This change was explained in the following terms:

> The conference agreement limits the F reorganization definition to a change in the identity, form, or place of organization of a single operating corporation. . . .
>
> This limitation does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved. The reincorporation of an operating company in a different State, for example, is an F reorganization that requires that more than one corporation be involved.[12]

The new definition became effective for all transactions occurring after August 31, 1982, except for those where the plan of reorganization was adopted prior to August 31, 1982 and actually consummated before January 1, 1983.

The term "operating corporation" is not defined in either the statutory amendment or any of the Committee reports accompanying the Tax Equity and Fiscal Responsibility Act of 1982. Presumably, the term is intended to distinguish corporations actively conducting a trade or business from holding companies and investment companies. It has been suggested that the above-quoted statement could be interpreted so as to preclude mere changes in the identity, form, or place of organization of non-operating companies from the application of the Type F reorganization.[13] Clearly, Congress in enacting this amendment was concerned with the propriety of extending the Type F reorganization to combinations of more than one active corporation. There is nothing in either the history of the development of the Type F reorganization concept, or in the revised wording of the statutory definition to suggest that Congress intended per se to deny transactions involving nonoperating corporations the benefits of the Type F reorganization. Additionally, the upstream merger of a single operating subsidiary into its holding company parent should continue to qualify as a Type F reorganization, just as it was held to so qualify under prior law.[14]

Although mergers of multiple, commonly-owned operating corporations no longer qualify as Type F reorganizations, taxpayers may, in some instances, have a plausable argument for avoiding the Section 381(b)(3) prohibition and carrying back post-merger losses under Section 172 on the theory that there has been "no complete liquidation" of the transferor corporation.[15] The principal shortcoming of such an argument is that in order to escape classification as a "reorganization," the merged corporations would have to be viewed as comprising, in substance, a single taxable entity both before and after the amalgamation. By so viewing the corporations, a merger between them would be viewed merely as an "internal" transaction, comparable to the elimination of separate divisions within a single corporate entity. No change would be deemed to have taken place in the identity of the tax "entity" and Section 381 would thus not be controlling.

The difficulty with this rationale is that corporations are generally treated as independent taxable entities irrespective of the fact that they may be owned by the same shareholders.[16] Indeed, in each of the pre-TEFRA decisions involving combinations of multiple operating corporations where the carryback of net operating losses was granted, the courts imposed a Libson Shops[17] restriction on such carryback. It is thus clear that the onlygrounds upon which the carry back of the loss was allowed was that the transaction qualified as a Type F reorganization.[18] Had the courts merely considered the commonly-controlled corporations to be one and the same tax entity, such restriction would not have been in order inasmuch as Section 172, which applies to carrybacks of a single continuing entity, does not impose any such restrictions upon a tax entity which operates more than one distinct enterprise.[19] The argument that a post-transaction loss carryback should be allowed under the "no complete liquidation" theory would seem to be strongest where there is a complete identity of the shareholders of the amalgamated

corporations and such corporations have filed consolidated returns for the year to which the carryback is sought.

Legislative History

The restriction of the Type F reorganization to transactions involving but one operating corporation was proposed for the first time by Congressman Stark (Chairman, Subcommittee On Select Revenue Measures of the Committee On Ways and Means) on May 6, 1982 as part of the proposed "Corporate Takeover Tax Act of 1982".[20] The announced purpose of this proposal was expressed in the following terms:

> . . . . F reorganizations are excluded from [the limitations of Section 381(b)] in recognition of the intended scope of such reorganizations as embracing only formal changes which do not require the reorganized corporation to be viewed as a new entity. . . .
>
> A number of court decisions have expanded the F reorganization definition in recent years to include fusions of active affiliated companies as long as there is sufficient identity of proprietary interest and there is uninterrupted business continuity. One case treated the merger of 123 affiliated corporations as an F reorganization. The exceptions for F reorganizations from the requirements of existing law closing the taxable year of a transferor corporation and restricting loss carrybacks, are not appropriate to fusions of two or more active business corporations.[21]

Hearings on this Bill were held on May 24, 1982. On June 28, 1982, a revised and scaled-down version of the original Bill was introduced. The provision restricting the scope of the Type F reorganization, however, remained intact.[22] Although many of the proposals contained in the proposed "Corporate Takeover Tax Act of 1982" were incorporated in the bill which eventually became the Tax Equity And Fiscal Responsibility Act of 1982,[23] neither the House nor the Senate version contained a provision for the modification of Section 368(a)(1)(F). This change was added to H.R. 4961 in the House/Senate Conference.[24] The Conference version of the bill was approved by both the House and the Senate on August 19, 1982 and was signed into law by President Reagan on September 3, 1982. Prior to passage, the Senate Finance Committee conducted public hearings as to the merits of the changes which were about to be made to Subchapter C, but only after the Bill had been reported out to the full Senate.[25]

Reason for the Change

Both the statement of the Staff of the Joint Committee on Taxation explaining the provisions of H.R. 6295,[26] and the Conference Committee Report which accompanied the final version of the Act[27] state that the purpose of the restrictions imposed on the Type F reorganization was to restore it to what

was perceived as its "historical" role.

> . . . . F reorganizations are excluded from [the limitations of Section 381(b)] in recognition of the intended scope of such reorganizations as embracing only formal changes in a single operating corporation. (Emphasis supplied.)

Neither report cites any authority for this proposition. Nor does either offer independent reasoning for its conclusions as to the "intended scope" of the Type F reorganization. This purpose is also implied in the descriptive heading of Section 225 of the Tax Equity and Fiscal Responsibility Act of 1982, instituting the change, which was titled "Clarification of Section 368(a)(1)(F)." (Emphasis supplied.)

In interviews with staff members who worked with the Subchapter C provisions of both the proposed "Corporate Takeover Act of 1982" and of the Tax Equity and Fiscal Responsibility Act of 1982, the author discovered that

> Not a lot of thought was given to this proposal and there were no strong feelings among the members of the staff [of the Joint Committee on Taxation] one way or the other. Most of us just thought that it would be better to limit the Type F reorganization to its historical role.[28]

Nor was the change instituted to correct a perceived abuse.

> Question: Was the allowance of net operating loss carrybacks under Revenue Ruling 75-561 perceived as giving rise to unwarranted tax abuse, and, if so, was this change directed toward correcting such abuse?
>
> Response: Definitely not. The possibility that the allowance of carrybacks under such circumstances might constitute unwarranted tax avoidance was not considered by the staff members.[29]

Arguments Favoring the Extension Of Carryback Privilege To Amalgamations of Multiple Operating Corporations

It must be noted from the outset that adequate thought as to the possible ramifications of the restrictions placed upon the Type F reorganization by Tax Equity and Fiscal Responsibility Act of 1982 was not, in the author's opinion, given to this proposal prior to its enactment. Regarding the corporate tax law changes made by TEFRA, Professor Eustice observed

> It seems clear that the speed with which these provisions became law -- four months from introduction to final passage -- was indeed remarkable. Less laudable, however, was the lack of any effective opportunity for constructive comment by those not deeply enmeshed in the legislative intrastructure . . . . [F]or provisions as complex and far-reaching as many of the Subchapter C amendments contained in the new Act, this is a distressingly and potentially dangerous process. . . .[30]

The following analysis lends considerable support to this statement.

Generally stated, there are two independent lines of reasoning which favor the reinstitution of the multi-corporate Type F reorganization. First, the interpretation of the original purpose and intent behind Section 368(a)(1)(F) which gave rise to the Tax Equity and Fiscal Responsibility Act of 1982 revision is, in the opinion of the author, incorrect. Since this is the only basis upon which this action was instituted, it should either be recinded, or justified on other grounds. Secondly, from a policy standpoint, the denial of Type F reorganization status to transactions involving more than one operating corporation is incongruent with accepted tenets of U.S. federal income taxation. An examination of policy considerations reveals that not only should carryback privileges be extended to multi-corporate Type F reorganizations, but to all other non-divisive statutory reorganizations as well, subject to (1) the standards set forth under Section 382 (and, of course, 269), and (2) the Libson Shops tracing rule employed in the Stauffer decision and in Revenue Ruling 75-561.

Re-evaluation of the Original Purpose and Scope Of Section 368(a)(1)(F)

As noted above, the sole express reason behind Section 225(a) of Tax Equity and Fiscal Responsibility Act of 1982 was to "clarify" what was perceived to be the "intended" or "historical" role of the Type F reorganization. The staffs of the Joint Committee on Taxation and of the Subcommittee on Select Revenue Measures and the members of the House/Senate Conference Committee concluded, without elaboration or citation to any authority, that the original legislative intent behind the enactment of the Type F reorganization was that it be limited to transactions involving only one operating corporation.[31] A thoughtful analysis of the historical development of Section 368(a)(1)(F) reveals that there is little support for such a conclusion.

Pre-1954 Legislative History

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982, neither Congress nor the Treasury Department had provided much insight into the intended meaning and scope of the Type F reorganization.[32] Even today, the Regulations are void of even the slightest elaboration.[33] A

careful analysis of the legislative history of Section 368(a)(1)(F), sparse though it may be, does however provide some important clues.

Revenue Act of 1921

The Type F reorganization made its debut as part of Section 202(c)(2) of the Revenue Act of 1921, which stated that

> The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of a corporation, or of substantially all the properties of another corporation), a recapitalization, or mere change in the identity form, or place of organization of a corporation, (however effected); . . . (Emphasis supplied.)

Although the Committee reports and floor debates of both the House and the Senate contain lengthy discussions as the objectives sought to be accomplished by the numerous changes made to the revenue laws by the 1921 Act, they nevertheless failed to specifically address the last component of the reorganization definition.[34] Consequently, the origin of the language used, and the specific reason for the inclusion of this phrase in the statute will forever remain matters of speculation.

Perhaps part of the phrase was derived from one or more of the many contemporary corporate law treatises which indicated that changes in identity, name, and domicile were among those types of changes which might be involved in a reorganization.[35] The term "identity" has been defined as "the sameness of essential or generic character in different instances."[36] This word, standing alone, would obviously bring within the scope of the provision such matters as the change in the name of a corporation; the renewal, revival, or extension of its charter; and perhaps even modifications to a corporation's charter which expand its powers or cure pre-existing defects. The term "place of organization," on the other hand, clearly refers to the jurisdiction under which a corporation is chartered.[37] Standing alone, it would seem to endow all reincorporations involving only changes in domicile with nonrecognition status: viewing with equal favor intrastate, interstate, state-to-federal, and federal-to-state reincorporations.[38]

The remaining process described in the phrase is a "change in . . . form . . . ." The term "form" was almost certainly used here to connote a contrast with a change in substance, rather than to exempt from taxation changes in the legal form through which a business might be conducted.[39] Its inclusion in the statute was undoubtedly in large measure reflective of Congressional desire to capture the spirit of the developing body of case law which espoused the exhaltation of substance over form in applying the revenue laws.[40]

But not all changes in identity, form, or place of organization are sanctioned by the statute. only those changes which are "mere" changes will be tolerated. It might thus appear that by confining the application of the Type F reorganization to "mere" changes, most of the problems which might otherwise arise regarding the interpretation of this definition are eliminated: the provision contemplates only the most insignificant of changes and nothing more.[41]

But the literal application of this term to the three categories of changes it describes deprives the entire phrase of virtually all meaningfulness. First, when changes are made in the "identity, form, or place of organization," they are usually, if not always, directed toward the fulfillment of some meaningful objective, and consequently are not insignificant or "mere." The amendment of a corporation's charter for the purpose of expanding its powers could, for example, be classified as a "change in identity." But if the change is significant enough to warrant making it in the first place, it could hardly be classified as a "mere" change in identity. Nor would a change of domicile to another state where the laws of the old and new state of incorporation work substantial changes in the rights and relationship of the corporation and its shareholders be a "mere" change in the place of organization.[42]

Secondly, any transaction which would qualify as a merechange in identity, or as a mere change in domicile would also qualify as a mere change in form and not in substance. The statutory Type F definition, stripped of these superfluities, appears then to simply restate case law which, by 1921, was already replete with judicial directives mandating allegience to substance and not to form when interpreting the Sixteenth Amendment and the revenue acts enacted thereunder.[43] Thus, a transaction effecting what would be viewed by the courts as a mere change in form (or identity, or domicile) could not, even in the absence of the exemption set forth in the statute, give rise in and of itself to constitutionally taxable income.[44]

If the Type F reorganization was added simply to incorporate into the statute the then-current state of case law (i.e., substance, not form, is controlling) and nothing more, then the entire phrase should be interpreted only in that light. Its proper construction would thus be derived from an examination of those cases and administrative rulings which address the questions: "When is income realized?"; or "What constitutes a closed transaction?"[45] But if the phrase was added to the statute with the intention of building upon contemporary case law, then it must be construed as broadening the exemption therein provided, as adding something to that which already existed.

The rules of interpretation, which require "a considered weighing of ever relevant aid to construction"[46] to determine the design of the legislature, come into play only where the meaning of a particular statute is equivocal.[47] This observer contends that the seeming lack of amphibolicity of the phrase " . . . mere change in identity, form or place of organization of a corporation, however effected," is, upon closer scrutiny, more apparent than

real, and that the Type F reorganization was originally enacted to provide for something quite different from the inconsequential transactions the words appear to describe.

First, it may be presumed that Congress does not engage in the futile exercise of enacting intrinsically meaningless legislation.[48] But the phrase, literally construed, is just that: meaningless. As previously pointed out, businessmen simply do not make mere, meaningless, insignificant changes in the identity, form or domicile of their corporations; and without such changes, the Type F reorganization would have no possible application. Nor would a literal construction of the phrase add anything whatsoever to the already universally-embraced "substance over form" doctrine of contemporary case law.[49] Viewed thusly, its incorporation into the statute would have been nothing more than an exercise in futility.

A second point worth noting is that the terms used in the phrase itself are difficult to reconcile, if not outright incompatible, inter se. While only "mere" changes are allowed, such changes will be nontaxable . . . , "however effected."[50] The latter term is indicative of legislative intent to give the reorganization definition the broadest possible scope, and is in diametrical opposition to the former, extremely restrictive, qualifying term.[51] This ambiguity, together with the points set forth in the preceeding paragraph, amply justify resort to legislative intent to derive the proper construction of the original Type F reorganization.[52]

The record provides ample, but admittedly not conclusive, support for the proposition that Congress initially intended a much more liberal construction than the words themselves seem to favor. Not only does a literal interpretation render the phrase virtually worthless, but more importantly such a reading is contrary to the purpose and spirit of the reorganization legislation. These provisions were enacted by a Congress anxious to do everything in its power to hasten the post-World War I economic recovery of the Nation.[53] Having been informed that the reorganization provisions of the Revenue Act of 1918 were "blocking desirable business adjustments."[54] Congress restructured these provisions. In doing so, it stated its intentions in the following terms:[55]

> Probably no part of the income-tax law has been productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions . . . .
>
> . . . The preceeding amendments, if adopted, will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenues by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges.

In drafting its first effort toward the formulation of a meaningfully and coherent policy of taxing reorganizations, the mood of the Congress was unabashedly pro-business and pro-reorganization. The reorganization

provisions set forth in Section 202 of the 1921 Act were permissive, rather than restrictive, in their orientation.[56] To the maximum extent consistent with the prevention of unwarranted tax avoidance, any exchange which might reasonably be considered a reorganization was to be regarded as deserving of immunity from immediate taxation. It was only after years of experience with the original legislation and the unforseen abuses it was to produce, that this unrestrained euphoria of the 67th Congress gave way to skepticism and caution, and that congressional effort was redirected toward curing the now-pronounced congenital defects of the early reorganization provisions (and, by doing so, curtailing their application). But in 1921, it is quite clear that corporate reorganizations were to have occupied a most favored position within the overall scheme of income taxation.

The paradoxical nature of the phraseology employed by the draftsmen of the Type F reorganization definition must also be examined in attempting to derive its true intended meaning and significance. On the one hand, the words themselves appear to confine the role of the Type F reorganization to that of a folderol. Yet such an interpretation takes no accounting of the fact that during this formative period in the history of federal income taxation policy-makers frequently confused the "substance over form" doctrine with something closely akin to the present-day "wherewithal-to-pay" concept and the "continuity of interest" doctrine. Under the Revenue Act of 1918, the Senate Finance Committee declined to tax reorganizations, mergers, or consolidations on the grounds that they constituted "purely paper transactions."[57] The Secretary of the Treasury in 1919,[58] and both the House Ways and Means Committee and the Senate Finance Committee in 1924,[59] considered <u>all</u> types of reorganization (mergers, consolidations, recapitalizations, etc.) to be "merely changes in form and not in substance." In 1921, the Finance Committee had described such exchanges as involving the realization of a " . . . technical gain . . . (since) the taxpayer actually realizes no cash profit."[60]

Neither mergers, nor consolidations, nor transactions involving the exchange of one corporation's stock for the stock or property of another corporation nor recapitalizations, however, lack economic substance. Notwithstanding the potential problems imposed upon one whose economic gain is realized in a form other than that in which a tax would be payable, and notwithstanding the fact that the parties to an exchange might receive interests which represent a continuity of their pre-exchange economic interests (in that they have not really "cashed in" on a theoretical gain or closed out a losing venture), an exchange of DuPont stock for stock in U.S. Steel pursuant to a merger of the latter into the former would hardly be looked upon as a "purely paper transaction," or as involving a "mere change in form," or as giving rise only to a "technical gain." Nevertheless, these phrases were repeatedly used by Congress to describe such transactions. Thus, when Congress established an exemption for a "mere change in identity, form, or place of organization of a corporation, (however effect)," it is quite probable that they intended to provide for transactions just as substantial as those more succinctly denominated in the statute.[61]

In view of the arguments set forth in the preceeding pages,[62] the author believes that the following restatement of the reorganization definiiton is more reflective of the design of the 67th Congress regarding the Type F recrganization:[63]

> The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of a corporation, or of substantially all the properties of another corporation), recapitalization, or <u>any other</u> mere change in identity, form, or place or organization of a corporation, (however effected); . . .

Revenue Act of 1924

The Revenue Act of 1924, which expanded the reorganization definition to include corporate divisions, shortened the statutory definition of the Type F reorganization by deleting the words " . . . of a corporation, . . . ", but otherwise left the original definition unchanged.[64] The reason for this change is not disclosed in the legislative record. Perhaps it was made simply to reflect its draftsman's preference for a more concise expression. Or it may have been motivated by a desire to avoid any confusion which might have resulted in a situation where, for example, a change in the place of incorporation would require use of a second corporation (i.e., the merger of an operating corporation into a shell transferee, new-created in the desired jurisdiction).

Whatever the reason, one thing is abundantly clear: the deletion of the phrase "of a corporation" was not the product of any intention to modify the theory, whatever it was, underlying the 1921 version of the definition. In later years, the Commissioner would correctly argue that this change cannot be construed as the manifestation of any congressional intent to expand the scope of the Type F reorganization so as to include mergers of two or more commonly-owned operating corporations.[65] First, the Committee reports accompanying the 1924 Act neutralize any such assertion in that they describe the changes made to the original reorganization definition as nothing more than "minor changes in phraseology."[66] Second, mergers of commonly-owned operating corporations could be effected tax-free under other definitions of reorganization contained in the Revenue Act of 1924 (roughly corresponding to the Type A, Type B, Type C, and Type D reorganizations of the present-day statute).[67] And at that time, prior to the enactment of Section 381 in 1954, <u>identical</u> tax consequences accompanied <u>all</u> reorganizations, regardless of which specific definition a particular transaction qualified under. Consequently, there was simply no reason for Congress in 1924 to revise the Type F reorganization so as to include that which had already been provided for elsewhere. Although it is clear that Congress did not affirmatively <u>expand</u> the scope of the Type F reorganization definition in 1924 to embrace mergers of multiple operating corporations, it does not appear that the

original version of the definition was composed with a view to excluding such transactions.

No further changes were made in the statutory language of the Type F reorganization definition until 1982.[68]

The 1954 Code and Section 381(b)

Although the Conference Report appears to have concluded that the exclusion of the Type F reorganization from the operating rules of Section 381(b) to be a manifestation of Congressional intent that this reorganizational form be limited to transactions involving but one operating corporation, this may not necessarily have been the case. First, Section 381(b)(1) requires that the transferor corporation in an asset acquisition of the type governed by Section 381(a) close its tax year as of the date the assets are transferred to the surviving corporation. The only exception to this rule applies when the transaction qualifies as a Type F reorganization. The Conference Report implies that this is evidence of the enacting body's recognition that Type F reorganization involved but one operating corporation and that there was thus no potential for conflicting tax years between the transferor corporation or corporations and/or the transferee corporation.

While this argument is certainly not without merit, the exclusion of the Type F reorganization from this requirement might derive more from Congressional oversight than from any conscious effort to imply that the Type F reorganization was limited to transactions involving no more than one operating corporation. Note that even in a Type F reorganization involving but one operating corporation, there is no statutory requirement that the transferee corporation adopt the same tax year as its predecessor, and that in such instances Section 381(b)(1), since it excludes the Type F reorganization from this requirement, is in direct conflict with Section 441, which states that, except in the case of a "52/53 week" tax year a taxpayer's tax year can never exceed 12 calendar months. Given the central role of the "annual accounting period" concept of taxable income in the federal income tax system, and its direct constitutional origins,[69] Section 441 should no doubt prevail where the two are in conflict.[70] The result is that even where the transaction qualifies as a Type F reorganization, it must close its tax year as of the date of the asset transfer where this is necessary to avoid an accounting period in excess of 12 months. Consequently, multi-corporate Type F reorganizations would appear to be no less compatible with the statutory framework than is the uni-corporate version where the successor corporation has adopted a tax year which differs from that of the predecessor corporation.

The Conference Report further implies that the reason Type F reorganizations were excluded from the Section 381(b)(3) prohibition against net operating loss carrybacks was that the 67th Congress considered that reorganizational form as involving but one operating corporation. The legislative history of Section 381(b)(3) leaves little doubt that this

Congress' sole purpose in denying carrybacks in nontaxable asset acquisitions was that it did not want the transferee corporation to be allowed to carry back the post-merger losses of its pre-merger business to offset the pre-merger taxable income of the transferor corporation or corporations, and that it perceived the complexity of the accounting problems which would otherwise result in carrying out this restriction to be so overwhelming as to necessitate the prohibition.

> Section 381(c)(1) makes no provision for the carryback of net operating losses where there has been a merger or other reorganization. Some limitation upon carrybacks in reorganizations and mergers is justifiable on the ground that it is too complex in some cases to determine to which of several component corporations the loss of the surviving corporation is attributable.[71]

Insofar as the exclusion of the Type F reorganization from this rule, recall first that the House version of the Internal Revenue Code of 1954 contained no provision for carrybacks whatsoever. The House bill also abolished the Type F reorganization on the grounds that it was unnecessary. It was the Senate which, at the urgings of the American Bar Association's Section on Taxation, retained the Type F reorganization and excluded it from the carryback prohibition on the following grounds:

> In two important areas . . . the problem of allocating the loss is not involved and it is suggested that in such cases at least, there should be no limit on carrybacks. One is the case of a reincorporation of the same corporation in a different state, or upon the expiration of its charter. Another instance is that of the wholly-owned subsidiary which is liquidated into its parent, which parent suffers a net operating loss in the following year."[72]

Since the illustration which gave rise to the statutory exception involved a uni-corporate Type F reorganization, it is arguable that the 67th Congress considered the scope of Section 368(a)(1)(F) so limited; but the author does not believe this to be the case. It is well recognized that reports of the House Ways and Means Committee and of the Senate Finance Committee

> . . . do not, of course, take the place of the statute, and the statutory provision is not to be limited to the illustrations used in the committee reports unless it is clearly evident that the illustration was used for that purpose.[73]

Recall that the principal purpose of the loss carryback prohibition was that Congress did not want the transferee corporation to be allowed to carry back the post-merger losses of its pre-merger business to offset the pre-merger taxable income of the transferor corporation, and that it perceived that the complex accounting problems would be encountered in implementing this

restriction. As this purpose is not compromised by the extension of the Type F reorganization to multi-corporate transactions (subject to the tracing rule of Stauffer and Revenue Ruling 75-561), an interpretation of Type F reorganizations which limits its scope to uni-corporate transactions is not necessary to the implementation of express legislative intent behind the statutory exemption. Note further that none of the several different courts addressing the issue, other than the Tax Court, considered legislative history to preclude the combination of commonly-owned operating corporations from qualification as Type F reorganizations. And virtually all of them, at the Commissioner's urging, gave the matter considerable thought.[74] Furthermore, in Stauffer v. Comm., the Tax Court placed far too much reliance upon the terms used in the statutory definition and failed to carefully examine the legislative history behind the provision.[75]

Policy Considerations Favoring The Extension of the Carryback Privilege to Mergers Involving Multiple Operating Corporations

Of far more importance than an interpretation of legislative history to the consideration of whether the carryback privilege should be extended to multi-corporate Type F reorganizations is an assessment of the degree to which such a provision would conform to accepted tenets of taxation. The critical first step in identifying and resolving deficiencies in the tax system is the identification of the objectives which the tax law is, or should be, designed to meet, i.e., what attributes will distinguish "good" tax law from "bad" tax law. Inexplicably, such attributes have never really been adequately identified, defined, or prioritized.[76] But there seems to be a consensus that the federal income tax laws should be "equitable,"[77] and that they must be capable of efficient and effective administration.[78] Further, it is well recognized that the objective behind many of the present-day income tax provisions is the modification of behavior so as to facilitate the achievement of selected economic and social objectives.[79] It is also recognized that the tax law should be designed carefully so as not to inadvertently influence economic and social decisions in a manner which is detrimental either to the taxpayer involved or to the best interests of the nation.

It is submitted that the statutory amendment restricting the Type F reorganization to uni-corporate transactions fails to conform to these general standards.

Equity Considerations

Section 172 reflects Congressional recognition of the fact that business income often fluctuates widely from year to year and that some sort of carryover provision is necessary in order to mitigate the inequities which would otherwise result from an annual accounting period definition of taxable income.[80] If one accepts the basic argument as to the equity of net operating

loss provisions, it would seem patently inequitable to deny the continuing shareholders of the transferor/transferee corporations the benefit, albeit indirect benefit, of the net operating loss carryback. Where there has been no change in the ownership of the transferor and transferee corporations, these are precisely the same persons suffered the detriment of the tax on pre-transaction income in the first place. The following quote from the Stauffer, supra, decision says it all:

> Had Stauffer Illinois and Stauffer New York merged into Stauffer California, the latter could have carried back a post-merger loss to one of its own pre-merger taxable years. Regs. 1.381(c)(1)-1(b). Or, had Stauffer Illinois and Stauffer New York merger into Stauffer California followed by the acquisition of Stauffer California by Stauffer New Mexico as a subsidiary, a loss sustained by Stauffer California could have been carried back to a pre-acquisition taxable year of Stauffer California. Or, had Stauffer California reincorporated into Stauffer New Mexico and thereafter consummated a merger with Stauffer New York and Stauffer Illinois, a loss sustained by Stauffer New Mexico could have been carried back to a taxable year of Stauffer California. This condition of circumstances had led the petitioner herein to exclaim that she "(H)as been victimized by the old shell game . . . [T]he pea, i.e., the loss carryback, must be found under one shell or another . . ."[81] (Emphasis supplied by court.)

If the business goes under, as it did in Stauffer, before it can use a post-transaction net operating loss carryforward (where carryback allowance has been denied), then the effect is that the corporation is taxed on net income which, in the final analysis, it never really had.

It must also be pointed out that denial of carrybacks in multi-corporate Type F reorganizations is incongruent with provisions which allow such carrybacks under less deserving circumstances. Note that while post-merger losses of the business previously conducted by the transferor corporation cannot be carried back and used to offset its pre-merger income, such losses can be carried back to offset the pre-merger income generated by the transferee's business. Absent a tax-avoidance purpose, this is true even where the post-transaction realized losses accrued prior to the date of the merger.

Substance Over Form

It has long been recognized that economically equivalent transactions should give rise to like tax consequences. Under the revised definition of the Type F reorganization, purely formal differences producing virtually identical legal and economic end-results can give rise to drastically disparate tax consequences. Tax consequences aside, it usually makes little or no difference which of the two or more commonly-owned operating corporations being amalgamated is selected as the surviving corporation and

which is to be the disappearing corporation. Nevertheless, as the law presently stands, if the corporate entity chosen to be the transferor corporation happens to be the one containing the business which ultimately produces the post-transaction losses, the surviving corporation, and indirectly the shareholders, will be denied access to the disappearing corporation's pre-merger taxable income. If the parties chose to consolidate rather than merge, then none of the pre-transaction taxable income of any of the transferor corporations is available to generate a refund from a post-transaction net operating loss carryback.

The author thus contends that the statutory restriction of the Type F reorganizations to transactions involving but one operating corporation is antithetical to the notion that economically equivalent transactions should give rise to like tax consequences.[82] In an area where the stakes are often very high, the risk of the loss of future tax benefits can serve to quell necessary and deserving [83] transactions, or to bring financial hardship (or even ruin) ex post where the path chosen subsequently proves to have been the wrong one.[84]

The restriction of the Type F to mergers involving single operating corporations, if permitted to stand, can be expected to impede deserving and necessary business readjustments.

Administrative Considerations

Prevention of unintended tax avoidance.

Many provisions of the federal income tax statutes have been inspired by the need to protect the laws from unintended abuses. Frequently, the concern for the adequacy of anti-tax-avoidance safeguards overrides equity or economic considerations.[85]

As regards the allowance of net operating loss carrybacks to mergers and consolidations of commonly-owned operating corporations, note that such transactions are seldom, if ever, inspired by tax avoidance motives.

> One fact that necessarily colors loss carryback cases is that the issue is not likely to arise in a tax avoidance setting. On the contrary, the facts will typically involve taxpayers victimized by unexpected losses or poor tax planning; if losses had been anticipated, or even recognized as a possibility, it would normally be a simple matter to preserve a carryback on any postreorganization loss. Thus, in Stauffer the carrybacks could have been preserved without any need for litigation by choosing any one of a number of different formal routes to the end result sought. But no one planning the consolidation had any inkling of the disasterous postmerger losses that were in store.[86]

It is clear that under the pre-TEFRA interpretation of the Section

368(a)(1)(F), the tracing limitation of Stauffer and Revenue Ruling 75-561 prevents any of the parties from generating a "tax benefit" as a result of the transaction which they would not have been entitled to in its absence. Assuming no change in proprietary interest, the same parties who ultimately suffered the detriment of the original income tax obtain the benefit of the refund generated by the loss carryback.

Simplification.

Given the degree of legal and economic complexity typically associated with the planning and consummation of corporate reorganizations, it is not possible for the tax laws governing such transactions cannot to themselves be "simple." Nevertheless, the extensive pre-TEFRA experiences of both the courts and the IRS in dealing with multi-corporate Type F reorganizations have proven that the standards necessary to insure equity and neutrality, while at the same time preventing tax avoidance, are administratable.

The author concludes that there are no impediments to sound tax law administration which justify the elimination of the multi-corporate Type F reorganization, where the carrybacks are subject to the tracing rule of Stauffer/Revenue Ruling 75-561.

EXTENSION OF THE CARRYBACK PRIVILEGE TO ACQUISITIONS INVOLVING A SHIFT IN PROPRIETARY INTERESTS

Nature of the Problem

Changes in the ownership of a corporate entity generally have no effect upon such corporation's historical tax attributes. This result derives from the fact that the identity of the legal corporate entity is itself unaffected by such changes. In recognition of this fact, the statute contains no express provision for attribute carryover under such circumstances.[87] Conversely, where the legal identity of the corporation is not maintained, tax attribute carryover is made to depend upon Section 381, and is thus subject to conditions and limitations which would not otherwise be applicable.

Whether or not the legal identity of a particular corporate party to a reorganization will survive the transaction is frequently matter of little or no consequence in terms of the economic effect such transaction will have upon the respective parties. Notwithstanding, the path chosen may, from a tax standpoint, lead to markedly different results. As a policy matter, the lack of symmetry between the carryback rules applicable to asset acquisitions, on the one hand, and stock acquisitions on the other. is difficult, if not impossible to justify. Present Section 382(a), for example, permits even a 100% change in the identity of the owners of a continuing corporation without reducing the benefit of any net operating loss carryforwards or disallowing carrybacks, assuming, of course, that the business of the loss corporation does not change contemporaneously with the change in ownership.[88] Likewise,

post-affiliation net operating losses may be carried back to offset pre-affiliation taxable income (subject to the so-called "separate return limitation year" tracing rule, and the disallowance rules of Sections 382(a) and 269) even where the acquisition entails a substantial or even complete change in the identity of the acquired corporation's shareholders and the transaction involves the amalgamation of several corporations into one consolidated group of corporations.[89]

In yet another variation of the same theme, at least two courts have come to recognize the capricious nature of these rules, and have rendered decisions which prevent the inconsistent outcomes described above. Assume that P Corporation owns 100% of S Corporation. S Corporation itself conducts no business and its only asset is voting stock of its parent, P Corporation. On 12/31/84, S Corporation, using its P Corporation voting stock as sole consideration, acquires all of the stock of a heretofor profitable manufacturing corporation, T Corporation.[90] For the calendar year following the acquisition, the manufacturing business, which was continued without interruption, incurs a sizable net operating loss.

If the legal identity of T Corporation survived the acquisition, i.e., T Corporation was maintained as a wholly-owned subsidiary of S Corporation, it would be permitted to carry the 1985 loss back to offset the income that it had previously reported on its pre-merger federal income tax returns. If, on the other hand, T Corporation contemporaneously merged (or was subsequently liquidated) into S Corporation, Section 381(b)(3) would, unless the transaction qualified as a Type F reorganization, intervene to preclude such a carryback. This statutorily-mandated result is in no way compromised by the fact that the economic effect of this latter alternative, ignoring tax consequences, is equivalent to that of the former. In both instances, the same manufacturing concern, with the same assets and the same liabilities is conducted in the corporate form under the ultimate control of the same parties (i.e., the shareholders of P Corporation).

Judicial Remedies

In facts very similar to those presented in the merger alternative of the above scenerio, the Second Circuit Court of Appeals, in Aetna Casualty and Surety,[91] and the Ninth Circuit Court of Appeals, in Bercy Industries, Inc.,[92] permitted the respective taxpayers to carry back the postmerger net operating losses of the transferee corporation to offset the premerger taxable income of the transferor corporation. In Aetna Casualty and Surety, the appeals court justified its ultimate holding primarily on grounds that, notwithstanding a substantial shift in proprietary interests, the merger of the operating transferor corporation into the shell transferee corporation constituted a Type F reorganization. Subsequently, in denying the government's request for rehearing, the court offered an alternative justification for its original holding: irrespective of whether the transaction under review constituted a Type F reorganization, Congress did not intend Section 381(b)(3) be applied

where there were no problems in tracing the post-fusion losses of the acquired business to its pre-fusion tax returns. In Bercy Industries, Inc., the appellate court went even further by relying exclusively upon this latter rationale to reach the same result in a similar transaction that involved a much greater shift in proprietary interests.

In each case, the court appears to have been decisively influenced by the fact that the transaction actually consumated was the economic equivalent of alternatives under which net operating loss carrybacks would indisputably have been allowed.

Conclusions and Recommendations

In the opinion of the author, these decisions, and the ambiguities and problem areas that they reveal, support the extension of the carry back privilege to all nondivisive reorganizational forms, subject to (1) the same standards set forth in Sections 382 and 269 applicable to other tax attributes,93 and (2) the Stauffer/Revenue Ruling 75-561 tracing rule.

Thank you for providing me with an opportunity to voice my views regarding this important issue.

APPENDIX I:

AETNA CASUALTY AND SURETY CO.

Aetna Casualty and Surety Co. v. U.S.[1] involved a forward triangular merger of a profitable operating corporation into a 100% owned shell subsidiary corporation. Aetna Life Insurance Co. (hereinafter "Aetna Life") owned 61.61% of Aetna Casualty and Surely Co. (hereinafter "Old Aetna"), a corporation actively engaged in the sale of liability, fire, theft, property damage, and surety insurance. As a result of changes made in 1959 in the manner in which life insurance companies are taxed,[2] Aetna Life sought to reduce its federal income taxes by placing its Old Aetna stock directly in the hands of its shareholders. In order to make this divestiture nontaxable under Section 815(f)(3)(B),[3] it devised and consummated the following plan.

Aetna Life organized Farmington Valley Insurance Co. (hereinafter "Farmington Valley") as a wholly-owned subsidiary. To this corporation, Aetna Life transferred 13,300,000 shares of its own stock. Pursuant to a plan of reorganization, Old Aetna then merged into Farmington Valley whereupon the shareholders received the Aetna Life stock as consideration for their respective interests in Old Aetna. Aetna Life, by virtue of its 61.61% ownership of Old Aetna, received 61.61% of this stock which it promptly retired. The remaining 38.39% of the Aetna Life stock was distributed to the Old Aetna minority shareholders. Farmington Valley immediately changed its name to Aetna Casualty and Surety Co. (hereinafter "New Aetna") and continued, without interruption or modification, the business formerly conducted by the transferor corporation. Meanwhile, Aetna Life distributed all of its New Aetna stock to a trust for the benefit of all of its shareholders. Evidence of a proportional beneficial interest in the trust was attached to each Aetna Life share so that the Aetna Life stock and the proportional interest in the trust holding the New Aetna stock would be indivisible. An advance letter ruling was obtained from the Internal Revenue Service to the effect that the transaction constituted a Type C reorganization.

In the period immediately following the merger, New Aetna incurred sizable net operating losses which it sought to carry back to offset the premerger taxable income of Old Aetna. To sustain its claim to the carryback,[4] New Aetna forwarded several alternative arguments:

1. The transaction was not a reorganization at all, but rather a redemption of minority shareholders;

2. The transaction constituted a Type B reorganization;

3. The transaction constituted a Type F reorganization; and

4. Congress, in enacting Section 381(b)(3) did not intend for the restrictions contained therein to be applicable where an operating corportion is combined with a mere shell corporation, regardless of the tax label placed on the transaction.

If the taxpayer proved to be successful under either of the first two arguments, the carryback would be allowed under the general rules Section 172 which are applicable where there has been no change in the taxpaying entity. Under the last two arguments, the carryback would be allowed under Section 381(a) and (c) inasmuch as Section 381(b)(3), an exception to the general rule allowing carryovers in acquisitive reorganizations, would by inapplicable.

The taxpayer fared poorly at the trial level, where the U.S. District Court rejected each of the taxpayer's arguments and disallowed the carryback. The court first distinguished and criticized the Tax Court's holding in Casco Products Corp.,[5] where a reincorporation undertaken for the sole purpose (and having the sole effect) of squeezing out minority shareholders was held not to constitute a "reorganization" at all, but merely a redemption by the same continuing corporation. Since a reorganization had in fact taken place, the consequences flowing therefrom must be determined in the light of this reality.

The trial court likewise held for the government on the Type B reorganization issue and the Type F reorganization issue. The transaction did not constitute a Type B reorganization because the acquired corporation lost its unique legal identity by virtue of its merger into Farmington Valley. And, under the still-viable standards set forth by the Supreme Court in Helvering v. Southwest Consolidated Corporation,[6] the 38.39% shift in proprietary interests that resulted from the exchange of Old Aetna stock by its minority shareholders for stock of Aetna Life was far too great, in the opinion of the court, to warrant classifying the transaction as a Type F reorganization. In refusing to test continuity by segregating the "redemption" from the "reincorporation" on the grounds that the former was "functionally unrelated" to the latter, the court expressly declined to follow the lead of either the Fifth Circuit Court of Appeals in Reef Corp. v. Comm.,[7] or the Internal Revenue Service in Revenue Ruling 61-156.[8] The trial court not only disagreed with the basic philosophy behind the "functionally unrelated" approach, but held further that even if that approach were viable, its application should be limited to cases involving tax avoidance reincorporation schemes.

> Perhaps the key to understanding both Reef and Revenue Ruling 61-156 is to realize that they were both efforts to frustrate the "liquidation - reincorporation" stratagems with which the court and the IRS were faced. Such tax avoidance plans subvert the tax

laws and have created serious problems; courts and the IRS have been willing to hang decisions rejecting such stratagems in an acrobatic fashion upon any sections of the Code that seem convenient . . . . The attempt to reconcile positions taken by the Commissioner or the Tax Court where tax consequences of a different kind were at stake is unrewarding and the precedent value of those cases here is slight. . . .

In the case at bar, there is not tax avoidance scheme to be rejected . . . . Thus I decline to apply the step transaction logic of Reef and Revenue Ruling 61-156 to the distinguishable problem presented here . . . ."[9]

Stated differently, different standards of construction wereto be applied depending upon whose ox is being gored.[10]

Since the transaction did constitute a "reorganization," but did not constitute either a Type B or a Type F reorganization, the carryback sought by the taxpayer was disallowed under Section 381(b)(3).

On appeal, the Second Circuit Court of Appeals agreed with the district court in finding that a "reorganization," and not merely a "redemption," had in fact taken place, and that the contrary holding of the Tax Court in Casco Products, where the facts were very similar, was erronecus. It then reversed the lower court by holding that the transaction qualified as a Type F reorganization and that Section 381(b)(3) did not apply to preclude the carryback. The appellate court's perception of the legislative intent behind the allowance of carrybacks, generally. and carrybacks in corporate reorganizations, in particular, seems to have provided the basis upon which its interpretation of the Type F reorganization rested.

We believe that where the issue is whether a corporation is entitled to carryback after a corporate reorganization, Section 368(a)(1)(F) should be construed with particular sensitivity to the purpose of Section 381(b). The interplay between subsections (F) and (A)-(E) gains its principal significance under the Code through the application of Section 381(b). Since New Aetna was merely a corporate shell with no business of its own, none of the accounting problems which motivated Section 381(b)(3) is present here. Indeed, since New Aetna had no pre-reorganization tax history of its own, application here of the carryback prohibition contained in Section 381(b)(3) would prevent New Aetna from obtaining any carryback of its current losses, even though Section 381(b)(3) does not prevent acquiring corporations in other types of reorganizations from carrying back losses to their own

> pre-reorganization tax years. We do not believe that the mere fact that a redemption has occurred should lead to so Draconian a result, particularly since Section 172 manifests a legislative policy in favor of carrybacks which ordinarily would not be affected by a simple redemption.[11]

The court, as an initial matter, held that the redemption of the Old Aetna minority shareholders could be separated from the as "functionally unrelated" to the reincorporation. It held further that even if the the redemption and the reincorporation were to be viewed as components of the same integrated transaction, since a "redemption was not a characteristic of a reorganization"[12] the transaction must nevertheless be evaluated net of the effect of the redemption.

> Absent the shift in the proprietary interests of the minority shareholders of Old Aetna, there would be no basis for contending that the merger of Old Aetna into a shell corporation, which had no business or assets of its own, did not qualify as a Section 368(a)(1)(F) reorganization . . . . We know of no authority for the proposition that the merger of one corporation into a mere corporate shell does not constitute a Section 368(a)(1)(F) reorganization.[13]

Although this statement implies that changes in proprietary ownership, regardless of direction or magnitude, are of no consequence in assessing qualification as a Type F reorganization where one of the two corporations is a mere shell corporation, it is clear from statements made later in the opinion that the court recognized that some ownership changes could give rise to contrary results.

> Here, unlike Southwest Consolidated, there is merely a shift in the proprietary interest of the minority shareholders of Old Aetna. The transaction here involved cannot be described accurately as a "sale" of one corporation's assets to another corporation. We agree with the Fifth Circuit that the instant reorganization might begin to look more like a "sale" -- or at least might look less like a Section 368(a)(1)(F) reorganization and a redemption -- "if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation."[2]

Having allowed the carryback on these grounds, the court expressed no opinion as to whether the transaction might have also constituted a Type B reorganization.

The most significant, and controversial, holding of the Second Circuit Court of Appeals in this case was expressed, not in the original opinion itself, but rather in that court's denial of the government's request for rehearing.

> We are concerned here with a reorganization in which a corporation is merged into a corporate shell with no prior business or tax history of its own. Since this reorganization presents none of the accounting or allocation problems that might arise in reorganizations involving two corporations each with a prior business and tax history, we conclude that Congress did not intend the loss carryback to be unavailable. In our view, it makes no difference whether effectuating Congressional intent in the circumstance of this reorganization is achieved by construing Section 368(a)(1)(F) broadly to include the reorganization of Old and New Aetna, or by construing Section 381(b)(3) somewhatnarrowly so as to be inapplicable to this particular reorganization. Either way, a loss carryback favored by the policies of the Code, see Sections 172 and 832(c)(10), and not presenting the problems with which the prohibition of Section 381(b)(3) was concerned, is allowed.[15] (Emphasis supplied.)

The flaw with the court's holding that Section 381(b)(3) be "corstrued . . . narrowly" is that the express, unambiguous lanquage of the statute. to whatever degree it may or may not succeed in manifesting legislative intent, leaves little or no room for judicial construction: Assuming that the transaction is described in Section 381(a), if it constitutes a Type F reorganization, a carryback will be allowed, if it does not so qualify, the carryback will be denied. It is just that simple. In the opinion of the author, this belated alternate holding, notwithstanding the indisputable equity of the result to which it gives rise, is not merely a judicial interpretation of the law, but rather constitutes nothing less than an outright judicial veto of an unambiguous statutory provision. The propriety of this holding will be discussed further in connection with the decision of the Ninth Circuit Court of Appeals' in Bercy Industries where, under a more extreme set of facts, the court relied solely upon its interpretation of legislative intent behind Section 381(b)(3) in granting the taxpayer's claim for a net operating loss carryback.

APPENDIX II:

BERCY INDUSTRIES, INC.

Bercy Industries, Inc. v. Comm.,[16] involved facts very similar to those presented in Aetna, except that (1) the parent corporation of the acquiring shell corporation had no premerger ownership interest in the target corporation (and was thus not simply redeeming out a minority interest), and (2) the former shareholders of the target corporation ended up owning only 4.4% of the stock of the parent corporation.

Beverly Enterprises owned all of the stock of Beverly Manor, an inactive shell corporation with no assets (other than voting common stock it owned in Beverly Enterprises) or operating history of its own. Beverly Enterprises sought to acquire Bercy Industries, Inc. (hereinafter "Old Bercy"), an unrelated corporation, as a wholly-owned operating subsidiary by means of a forward triangular merger into Beverly Manor. Pursuant to a plan of reorganization, Beverly Manor exchanged all of the Beverly Enterprises voting common stock held by it for all of the outstanding stock of Old Bercy. As a result of this exchange, the shareholders of Old Bercy terminated their entire direct interest in Old Bercy and acquired an aggregate voting interest in Beverly Enterprises of 4.4%. Immediately after the merger, Beverly Manor changed its name to Bercy Industries, Inc. (hereinafter "New Bercy") and, without change or interruption, conducted the same business as that formerly conducted by Old Bercy. New Bercy unexpectedly incurred sizable net operating losses in the year following the merger and sought to carry them back to the premerger tax returns of Old Bercy on the grounds that the transaction qualified as either a Type B reorganization, or alternatively, that the legislative intent which gave rise to the enactment of Section 381(b)(3) rendered it inapplicable to the transaction under review.

The Tax Court ruled that the transaction did not constitute a Type B reorganization inasmuch as the target corporation, Old Bercy, ended up in a different corporate shell, Beverly Manor. It further implied a rejection of the alternative holding of the Second Circuit in Aetna.

> There the court was able to root its argument on a finding that an (F) reorganization had taken place . . . . We have no such lifeline here and we cannot apply that approach in a statutory vacuum.[17]

Without analysis or discussion it held that the shift from a 100%

direct proprietary interest to a 4.4% indirect proprietary interest was far too great to warrant the invocation of Section 368(a)(1)(F).

The Ninth Circuit Court of Appeals decided the case in favor of the taxpayer and allowed the carryback. It did so not by fitting the transaction into the Type B or Type F reorganization mold, but rather by finding that Congress never intended Section 381(b)(3) to apply where the nature of the reorganization did not give rise to complex accounting problems in allocating the postmerger losses back to the premerger income of the business which incurred those losses.

> . . . [T]he legislative history shows that Congress was concerned with a complex accounting problem -- deciding how a post-reorganization loss should be allocated between the acquiring corporation and the transferor corporations, and, therefore, how much of the loss should be carried back to offset each entity's income in the three preceeding tax years . . . . The Senate Finance Committee reported: "Some limitation upon carry-backs in reorganizations and mergers is justifiable on the ground that it is too complex is some cases to determine to which of several component corporations the loss of the surviving corporation is attributable . . . . (I)n two important areas . . . the problem of allocating the loss is not involved, and it is suggested that in such cases at least, there should be no limit on carrybacks . . . ." This lanquage strongly suggests that when a reorganization generates no complex problems of post-reorganization loss allocation, Congress intended that the surviving corporate taxpayer be able to carry back such losses without limitation.[18]

While the court's assessment of the legislative intent behind the enactment of Section 381(b)(3) is most convincing, the enacted statute explicitly denies loss carrybacks where the corporate acquisition is other than by means of the Type B or Type F reorganization. Good or bad, right or wrong, the Internal Revenue Code does not mitigate this troublesome and potentially inequitable precondition by expressly establishing an exception for situations where no "complex allocation problems" arise, nor does it in any way imply such an exception. While, it is well-established that the reports of the Congressional committees may be of great usefulness to the courts in determining legislative intent where the statutory lanquage is ambiguous, they do not take the place of the enacted statute, and are of no value where the law is articulated clearly and unequivocably.[19] However sympathetic the taxpayer's plight in Bercy might have been, the remedy, if there was to be a remedy, should only have come as a result of Congressional reconsideration. In the opinion of the author, the court far exceeded the scope of judicial perogative in granting the carryback. Additionally, the decision raises extraordinarily difficult questions as

to just when and to what extent carrybacks might be allowed by the courts in reorganizations which involve more than one operating corporation, or where the shift in ownership is, to a greater or lesser extent, the result of a taxable exchange.[20]

In addition to holding that exemption from Section 381(b)(3) could be had under circumstances not enumerated in the statute, the court held that such carrybacks should be allowed without regard to whether and to what extent the ownership of the corporation, between the time the income was earned and the losses were ultimately sustained, has changed.[21] In so holding, it recognized two inconguent theories upon which Congress constructed the statutory carryover provisions.

> The Commissioner makes much of the fact that because of the reorganization, the benefit of the loss carryback will accrue to a different set of shareholders than the one that owned Bercy at the time it earned the income to be offset. We fail to see why this should prevent the carryback. Sections 381 and 382 are grounded on two competing theories: (1) A loss carryback ought to be available only when the shareholders who were the "beneficial sufferers" of such loss retain an interest in its use, as the Commissioner argues; and (2) a loss carryover ought to be available only for use against the profits from business activities which gave rise to the loss . . . . These two theories conflict in large degree, so that any particular subsection of Section 381 or 382 may favor one theory over the other. As our discussion on Congressional intent indicates, . . . this was the case with Section 381(b)(3); theory (2), rather than theory (1) clearly animates subsection (b)(3).[22]

The court seemed especially impressed by the fact that shifts in proprietary interests, regardless of their magnitude, generally have no effect on the corporation's right to the carryback where the acquisition is by means of a "reverse," instead of a "forward," triangular merger.[23]

Although the court rested its opinion upon its perception of the legislative intent behind Section 381(b)(3), some of the wording it used in its opinion indicates that it may have considered the transaction to have constituted a Type F reorganization, at least for the purpose of applying that provision where net operating loss carrybacks was at issue.

> [The Commissioner] further argues that the reorganization transformed Old Bercy economically by shifting control of the corporation from its own shareholders to those of Beverly Enterprises . . . . [W]e are not persuaded that [such] a material change in the identity resulted from the reorganization here at issue. The reorganization involved only one set of operating

assets, one set of books, and one tax history. New Bercy is operating the same commercial business that Old Bercy operated."24 (Emphasis supplied.)

Although these two appellate decisions carry the potential for major changes in the manner in which postmerger net operating losses are treated, recent developments may have the effect of limiting their significance. While the wording of the opinions of both Aetna and Bercy seems broad enough to encompass mergers of multiple operating corporations (even where such corporations are not commonly-owned) where "complex allocation problems" do not exist, the recent decision of the 97th Congress to restrict the Type F reorganization to reincorporations involving but one operating corporation will probably have the effect of preventing these precedents from extending too far beyond the fact patterns evidenced in these respective cases. More fundamentally, recall that the application of new Section 382(a) is predicated solely upon change in ownership, irrespective of whether a contemporaneous change in business occurs. Similarly, new Section 382(b) will extend the change in ownership rules to both Type B reorganizations and triangular reorganizations and will test for the survival of beneficial tax attribute carryovers by reference to the relative interest of the loss corporation's shareholders in the surviving corporation. Should these provisions ever be permitted to become effective, they will not only have the general effect of reducing the dollar amounts of net operating loss carryover at issue, but will mandate a reexamination of the fundamental motives behind the carryover rules. As the allowance of carryovers will look exclusively to ownership changes irrespective of business continuity or transactional form, the courts will likely conclude that the Ninth Circuit's "theory (1)" (shareholder continuity, not business continuity, the touchstone for carryovers) has become the dominant force behind the allowance of carryovers generally and behind Section 381(b)(3) in particular.

FOOTNOTES TO TESTIMONY

[1]U.S., Congress, Senate, Committee on Finance, Hearings on H.R. 8300, 83rd Congress, 2d Session (1954): 405. See also: Joseph M. McManus, "Judicial Law-Making: The Liquidation of a Corporation Treated as an F Reorganization," Journal of Corporate Taxation 2 (Autumn, 1975): 280 to 283; and Berry Industries, Inc. v. Comm., 640 F.2d 1058 (CA-9, 1981).

[2]Compare Helvering v. Southwest Consolidated Corporation, 315 U.S. 194 (1942), with Aetna Casualty and Surety Co. v. U.S., 568 F.2d 811 (CA-2, 1976) and Berry Industries, Inc. v. Comm., 640 F.2d 1058 (CA-9, 1981).

[3]The carryback of the operating loss generated by the business formerly conducted by the transferor corporation to the premerger taxable income of the transferee corporation is not prohibited.

[4]366 F.2d 874 (CA-5, 1966). But see the Tax Court's decision in Pridemark, Inc., 42 T.C. 510 (1964) rev'd. 345 F.2d 35 (CA-4, 1965).

[5]See, for example, Davant v. Comm., supra., note 4.

[6]See, for example, Eastern Color Printing Company, 63 T.C. 27 (1974), Stauffer v. Comm., 403 F.2d 611 (CA-9, 1968), rev'g 48 T.C. 277 (1967), and Performance Systems, Inc. v. U.S., 382 F.Supp. 525 (D.C, 1973). aff'd per curiam 501 F.2d 1338 (CA-6, 1974).

[7]1975-2 C.B. 129.

[9]48 T.C. 277 (1967), rev'd. 403 F.2d 611 (CA-9, 1968).

[10]1978-2 C.B. 146.

[11]1978-2 C.B. 152.

[12]U.S., Congress, House/Senate Conference Committee, Conference Report, H.R. No. 760, 97th Congress, 2nd Session (1982): 541.

[13]See Research Institute of America, The RIA Complete Analysis of the '82 Tax Equity and Fiscal Responsibility Act (Research Institute of America: New York, 1982): 287.

[14]See Eastern Color Printing Company, 63 T.C. 27 (1974), wherein the Tax Court (which, to the end, opposed combinations of multiple operating corporations) found a Type F reorganization under precisely these circumstances.

[15]See Reg. Section 1.331-1(c) (discussed supra., pp. 307 to 310), and the Fifth Circuit Court of Appeals' decision in Davant v. Comm., 366 F.2d 874 (CA-5, 1966), discussed supra., 367 to 371, where the court held that the merger of one operating corporation into another owned by the same

shareholders in the same proportions did not constitute a bona fide liquidation of the transferor corporation and that Section 301, rather than Section 356, therefore applied in determining the amount of dividend income resulting therefrom to the shareholders. See also the discussion of the Telephone Answering Service Corporation decision supra., at pp. 381 to 371.

[16]See generally Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, 4th ed. (Boston: Warren, Gorham. and Lamcnt. 1979): pp. 1-14 to 1-22 ("The Corporation as an Entity").

[17]Libson Shops v. Koehler, 353 U.S. 382 (1957).

[18]The Tax Court in Casco Products Corporation, 49 T.C. 32 (1967) (discussed supra., pp. 432 to 436) and the Ninth Circuit Court of Appeals in Bercy Industries, Inc. v. Comm., 640 F. 2d 1058 (1981) rev'g 70 T.C. 29 (1978) (discussed supra., pp. 465 to 472) both allowed the carryback of postmerger net operating losses to the premerger income of the transferor corporation on grounds other than that the transaction constituted a Type F reorganization, but in both of these cases only one operatng corporation was involved.

[19]Rev. Rul. 63-40, 1963-1 C.B. 46.

[20]H.R. 6295 (Section 302(a)).

[21]Staff of the Joint Committee on Taxation, Description of Tax Bills Relating to Tax Treatment of Corporate Mergers and Acquisitions (1982): 19.

[22]U.S., Congress, House, Committee on Ways and Means, H.R. 5725(1982): Section 202(a).

[23]Introduced as H.R. 4961, enacted as P.L. 97-248

[24]Mr. Stark was one of the House conferees.

[25]Senate Finance Committee reported its version of H.R. 4961 to the full Senate on July, 12, 1982, and held these hearings three days later on July 15. The Senate passed H.R. 4961 on July 23, 1982.

[26]Staff of the Joint Committee on Taxation, Description of Tax Bills Relating to Tax Treatment of Corporate Mergers and Acquisitions (1982): 19.

[27]U.S., Congress, House/Senate Conference Committee. Conference Report, H.R. No. 760, 97th Congress, 2nd Session (1982): 541. Note that the wording of the Conference Committees reason for the change differs slightly from that articulated in the explanation in the report of the Staff of the Joint Committee on Taxation.

[28]Mr. James Dring, member of the Staff of the Joint Committee on Taxation, in a conversation with the author on December 14, 1982.

[29]Mr. Dring, supra. In accord, Mr. James Jonas, Chief Counsel of the

Staff for the Subcommittee on Select Revenue Measures, in a conversation with the author on the same day.

[30]James S. Eustice, Tax Equity and Fiscal Responsibility Act of 1982 Special Supplement (to Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations and Shareholders, 4th ed. (Boston: Warren, Gorham, and Lamont, 1979).

[31]See James A. Bradley, "Tax Reform: Statutory Clarification of the F Reorganization," TAXES—The Tax Magazine 53 (August, 1975): 490-505, wherein the author argues for a legislative mandate limiting the Type F reorganization to transactions involving a single corporation. His sole basis for such a proposal (and for his criticism of the decisions extending the Type F reorganization to multi-corporate amalgamations) is that the wording of the original definition in the Revenue Act of 1921 and the legislative intent in excluding the Type F reorganization from the limitations set forth under Section 381(b) conclusively evidence Congressional intent to preclude its application to mergers and consolidations involving more than one operating corporation.

[32]The term "Type F reorganization" will be used throughout this section to reference the pre-TEFRA'82 form of the statutory phrase (" . . . a mere change in identity, form or place of organization (however effected)").

[33]Treasury Regulation 62, Article 1566(b) (the Revenue Act of 1921) refers to the Type F reorganization as involving an "internal adjustment" in the affairs of a corporation. In 1924, Treasury Regulation 65, Article 1577 (Revenue Act of 1924) dropped the reference to the Type F reorganization as an "internal adjustment" and simply reproduced the statutory phrase without further discussion as to its purpose or meaning. This approach was followed by Treasury Regulation 69, Article 1577 (Revenue Act of 1926), and Article 577 of Treasury Regulation 74 and 77 (Revenue Acts of 1928 and 1932, respectively). In 1935, the Regulations permanently abandoned even this reference to the Type F reorganization. Article 112-(g)-2 of Regs. 86, 94, and 101 (interpreting the Revenue Acts of 1934, 1936 and 1938, respectively); Treasury Regulation Secs. 19.112(g)-2 (1939-1940) and 29.112(g)-(2)(1941)-1954) under the Internal Revenue Code of 1939; and Treasury Regulation Sec. 1.368-2 under the Internal Revenue Code of 1954.

[34]U.S., Congress, House, Committee on Ways and Means, House Report No. 350, accompanying H.R. 8245, 67th Congress, 1st Session, August 16, 1921). U.S., Congress, Senate, Committee on Finance, Senate Report No. 275, accompanying H.R. 8245, 67th Congress, 1st Session, Sept. 26, 1921. See also U.S., Department of the Treasury, Notes on the Revenue Act of 1918 Submitted by the Secretary of the Treasury, Without Recommendation at This Time, 1919. It was proposed in this document to define "reorganization" to include "a merger, consolidation, or a mere change in identity or form or organization of a corporation or partnership; . . . "

[35]In Seymor D. Thompson, Commentaries on the Law of Private Corporations, 2nd ed. (Indianapolis: The Bobbs-Merrill Company, 1910): p.

804, for example, the author states:

> "Reorganization imply means the act or process of organizing again or anew. In the law of corporations, it means only what the term itself indiates, that a corporation has by some process organized anew; an yet it implies that some of the features of the old corpontion are retained. The term is applied indifferently to he various proceedings by which a change or renewal of the orporation is accomplished, as well as to proceedings by whin an existing corporation is continued under a different organiation, though it may or may not be the creation of a new corporatin. Reorganization is not essentially different from reincorporation . . . . However, as suggested, the reorganization may continue an existing corporation, without any dissolution, under the same or a different name, and without affecting the idenity of the corporation."

See also: William L. Marshall and William L. Clark, Marshall on Private Corporations (Saint Paul: Keefe-Davidson Company, 1902); and William Meade Fletcher, Cyclopedia of the Law of Private Corporations, (Chicago: Callaghan and Co., 1919), pp. 8465-8477.

36 Webster's New Collegiate Dictionary, (Springfield, Mass.: Merriam Company, 1979).

37 Article 1566(b) of Regulations 62 (Revenue Act of 1921) use the word "domicile" as a synonym for "place of organization."

38 "The term 'place of organization' must, in order to have any real meaning, refer to the state of incorporation." Randolph E. Paul, and Jacob Mertens, Jr., The Law of Federal Income Taxation (Chicago: Callaghan and Company, 1934), p. 210.

39 Transactions which effected a change in the legal form of organization were specifically addressed in other provisions of the Revenue Act of 1921. The incorporation of a partnership or proprietorship could be totally or partially nontaxable under Section 202(c)(3), a provision roughly analogous to Section 351 of the Internal Revenue Code of 1954. The Revenue Act of 1918 and prior acts established no such exemption for the incorporation of a new or continuing business.

Section 201(c) of the Revenue Act of 1921, however, required the distributee-shareholder to recognize any realized gain or loss upon the distribution of cash or other property in complete liquidation of the corporation. This provision set forth no exception for liquidations in which the business of the liquidated corporation was to be continued in the partnership or proprietorship form.

It is interesting to observe, however, that the Revenue Acts of 1917, 1918, and 1921 each contained a provision which expressly characterized as a "reorganization" the incorporation of a "trade or business" previously conducted as a partnership or proprietorship. (Sections 208, 330, and 331, respectively). These provisions, however, dealt with reorganizations as they affected "invested capital" for

excess profits tax computations, rather than with the exchange transactions themselves.

In 1919, the Secretary of the Treasury proposed that the exemption from taxation afforded corporate reorganizations by the Revenue Act of 1918 be extended to include reorganizations of partnerships, and that the term "reorganization" be defined in the statute to include "a merger, consolidation, or a mere change in the identity or form or organization of a corporation or partnership." A reading of the entire proposal, however, clearly indicates that neither the incorporation of an unincorporated business, nor the reverse process, was intended by Secretary Glass to constitute a nontaxable "reorganization." U.S., Department of the Treasury, Notes on the Revenue Act of 1918. Submitted by the Secretary of the Treasury. Without Recommendation at This Time (1919), p. 7-8.

[40]Lynch v. Turrish, 247 U.S. 221 (1918); Southern Pacific Co. v. Lowe, 247 U.S. 330 (1918); Eisner v. Macomber, 252 U.S. 189 (1920). See also the discussion presented and the cases cited at pp. XXX to XXX. According to Randolph Paul:

> "The provision apparently was intended in a catch-all sense and to include among the nontaxable reorganizations exchanges of interests similar to those which in a number of instances had been held by the Supreme Court not to result in the realization of gain or loss because the taxpayer received nothing substantially different from what he had before." (Randolph E. Paul, and Jacob Mertens, Jr., The Law of Federal Income Taxation, (Chicago: Callaghan and Company, 1934): p. 210.)

While the courts were unanimous in praising the virtues of substances over form, the application of the distinctions inherent therein to actual controversies proved, at best, confusing and contradictory.

[41]See, for example, N. Jerold Cohen, "The E and F Reorganizations: Use and Abuse; Use as a Part of a Major Reorganization Plan," 31st Annual N. Y. U. Institute on Federal Taxation (New York: Mathew Bender, 1973): 334.

[42]"It would seem that ordinarily, where the effect of the laws of several states was not too materially different, such a change was intended to be covered by this provision." (Emphasis supplied.) (Randolph E. Paul, and Jacob Mertens, Jr., The Law of Federal Income Taxation, (Chicago: Callaghan and Company, 1934): p. 210.)

[43]Supra, note 40.

[44]See Eisner v. Macomber, 252 U.S. 189 (1920).

[45]See discussion of some of these cases infra., pp. 37 to 46. See also two early works which address these questions: Thomas S. Adams, "When is Income Realized," and Robert H. Montgomery, "Reorganizations and the Closed Transaction," both in Haig, Robert H. Federal Income Tax,

ed. Robert M. Haig (New York: Columbia University Press, 1921): 29-50 and 134-136, respectively.

[46] U.S. v. Dickerson, 310 U.S. 554 (1940). See U.S. v. Fisher, 6 U.S. 358 (1804) wherein Chief Justice Marshall stated:

> "Where the mind labors to discover the design of the legislature, it seizes everything from which aid can be derived; . . . "

[47] Caldwell v. U.S., 114 F.2d 995 (CA-3, 1940); Santa Monica Mountain Park Co., Ltd. v. U.S., 99 F.2d 450 (CA-9, 1938); U.S. v. Beaver Run Coal Co., 99 F.2d 610 (CA-3, 1938); Fay Trust "A", 42 B.T.A. 765 (1940).

[48] The literal meaning of words cannot be insisted upon so as to defeat the purpose of a tax statute. Miller v. Milwaukee, 272 U.S. 713 (1927); Carbon Steel Co. v. Lewellyn, 251 U.S. 501 (1920). The statute should be construed with regard to the subject matter and the nature of the business involved. Woolford Realty Co. v. Rose, 286 U.S. 319 (1932). A construction which would render a provision meaningful is preferred over one which would render it meaningless.

[49] In O.D. 788, 4 C.B. 45 (1921), the Bureau of Internal Revenue stated that Section 202(b) of the Revenue Act of 1918, was new law and was "not declaratory of the rule existing under previous acts."

[50] The House version of the definition of a reorganization read as follows:

> " . . . The word 'reorganization' . . . includes a merger or consolidation (however effected), recapitalization, or a mere change in identity, form, or place of organization; . . . "

In the Senate, the location of the term "however effected" was shifted to the end of the sentence so as to modify the entire definition. This change was made, without discussion or explanation, at the behest of Dr. T. S. Adams, tax advisor to the Treasury Department. U.S., Congress, Senate, Committee on Finance, Hearings Before the Committee on Finance on H. R. 8245, 67th Congress, 1st Sess., September 1 through October 1, 1921, at page 202. Nor was any explanation for the change set forth in the Conference Report. U.S., Congress, House, Committee on Ways and Means, House Report No. 486, 67th Cong., 1st Sess., November 19, 1921, at p. 17 (see "Amendment No. 47").

[51] Notice the markedly different connotations which emanate from the two abbreviated definitions:

1. "A mere change in identity, form or place of organization of a corporation."

— versus —

2. "A change in the identity, form, or place of organization of a corporation, however effected."

[52] " . . . Every statute is to be construed with reference to its

intended scope and to the purpose of the legislature in enacting it; and where language is used which admits to more than one meaning, it is to be taken in such a sense as will conform to the scope of the act and carry out the purpose of the statute, being mindful, however, that it is not permissible under the pretense of interpretation to make a law, either by extension or restriction, which shall depart from the legislative intent . . . ." Comm. v. Maguire, 111 F.2d 843 (CA-7, 1940), aff'd. 313 U.S. 1 (1941).

Congressional intent, as derived from the legislative history, is frequently a determinative factor in the interpretation of tax statutes. All of the prenatal forces brought to bear upon the statute in question during its gestation must be identified and weighed to discover such intent: the circumstances prompting enactment (e.g., Carbon Steel Co. v. Lewellyn, 258 Fed. 533 (CA-3, 1919), aff'd. 251 U.S. 501 (1920)), and the history of the times (e.g., Helvering v. Morgan's Inc., 293 U.S. 121 (1934)). One must " . . . reinstate the circumstances in which the words were uttered." Learned Hand, J., dissenting in Pfeiffer v. Comm., 88 F.2d 3 (CA-2, 1937).

The reports of the House Ways and Means Committee and the Senate Finance Committee are important aids in determining congressional intent. E.g.: Mutscheller v. Comm., 298 U.S. 685 (1935); White v. U.S., 305 U.S. 281 (1938).

See, generally, Jacob Mertens, Law of Federal Income Taxation, vol. 1 (Chicago: Callaghan): Sees. 3.25-3.30.

[53] "The nation is now passing through the trying period of liquidation and readjustment. The reduction of the tax burdens is essential to business recovery . . . ." (From the preface to U.S., Congress, House, Committee on Ways and Means, House Report No. 350, accompanying the Revenue Act of 1921, 67th Congress, 1st Sess., August 16, 1921, p. 1.)
See also Senator Watson's statement during discussion of Section 202 on the floor of the Senate:

> " . . . [A]t a time when so much reorganization is going on in the business world, it is thought by all those interested in upbuilding of the industries of the country at this time that this is a very helpful provision . . . " (Congressional Record, volume 61, pp. 6561-6566).

[54] Dr. T. S. Adams, tax advisor to the Treasury Department, in U.S., Congress, Senate, Committee on Finance, Hearings Before the Committee on Finance on H.R. 8245, 67th Congress, 1st Session, September 1-October 1, 1921, at p. 29. (See also the testimony of Frederick R. Kellogg at p. 128.)

[55] U.S., Congress, House, Committee on Ways and Means, House Report No. 350, accompanying H.R. 8245, 67th Congress, 1st Session, 1921, at p. 10. These statements make reference to not only the "old" and the "new" reorganization provisions, but also to other classes of exchanges, such as exchanges of "like-kind" property and transfers to "controlled" corporations in exchange for its stock or securities. See also U.S.,

Congress, Senate. Committee on Finance, Senate Report No. 275, accompanying H.R. 8245, 67th Congress, 1st Session, 1921, p. 11-12.

56 Recall that the definition of reorganization contained in Section 202(c)(2) of the Revenue Act of 1921 was an inclusive one: "The word 'reorganization' . . . includes . . . ." In the Revenue Act of 1924 (Section 203(h)(1), the definition became exclusive when "includes" was changed to "means."

57 U.S., Congress, Senate, Committee on Finance, Senate Report No. 617, accompanying H.R. 12863, 65th Congress, 3rd Session, December 6, 1918, pp. 5-6. Notwithstanding this reference to such transactions as constituting "purely paper transactions" and the attendant implication that "gain" thereby produced may not have been constitutionally realized even in the absence of Section 202(b) of the 1918 Act, the Treasury nevertheless stated in O.D. 783, 4 C.B. 45 (1921) that this provision was " . . . not declaratory of the rule existing under previous Acts . . . " and would therefore only be applied prospectively. Nor, apparently, did the Supreme Court consider Section 202(b) as merely an expression of that which was already implied in the 16th Amendment (i.e., What is "income"?). See U.S. v. Phellis, 257 U.S. 156 (1921); Rockerfeller v. U.S., 257 U.S. 176 (1921); Cullinan v. Walker, 262 U.S. 134 (1923); Marr v. U.S., 268 U.S. 536 (1925). But in Eisner v. Macomber, 252 U.S. 189 (1920) and Weiss v. Stearn, 265 U.S. 242 (1924), the Supreme Court held the slight changes in the form of the taxpayer's investment to be nontaxable. These cases were all decided after the effective date of the Revenue Act of 1918, but involved transactions consummated prior to that date.

58 U.S., Department of the Treasury, Notes on the Revenue Act of 1918 Submitted by the Secretary of the Treasury, Without Recommendation at This Time (1919), at pp. 7-8.

59 U.S., Congress, Senate, Committee on Finance, Senate Report No. 398, accompanying H.R. 6715, 68th Congress, 1st Session, April 10, 1924, at p. 17; U.S., Congress, House, Committee on Waus and Means, House Report No. 179, accompanying H.R. 6715, February 11, 1921, at p. 16.

(See also repeated references to the reorganization as a "purely paper affair" (Senator Watson), and "nothing more or less than a paper transaction" (Senator Most) on the floor of the Senate during discussion of the Section 212(c) of the Revenue Act of 1921. Congressional Record, volume 61, pp. 6561-6566.)

60 U.S., Congress, Senate, Committee on Finance, Senate Report No. 275, accompanying H.R. 8245, 67th Congress, 1st Session, Sept. 26, 1921, at p. 11. Senator Read articulated his justification for Section 202(c)(2) of the 1921 Act in the following terms:

> " . . . Where a man owns stock in a company which is merged with another, he simply exchanges stock for stock and acquires nothing new." (Congressional Record, volume 61, pp. 6561-6566.)

[61] In Boston Sand and Gravel Co. v. U.S., 278 U.S. 41 (1928) the majority opinion said:

"[Where] Congress has been accustomed to use a certain phrase with a more limited meaning than might be attributed to it by common practice it would be arbitrary to refuse to consider that fact when we come to interpret a statute." (At p. 48).

Presumably, the same dictum would apply where the meaning customarily given a word or phrase by Congress is broader than the meaning subscribed to be the public-at-large.

Nor should the use of the singular "of a corporation" be necessarily viewed as intending to limit the Type F reorgan- ization to internal adjustments to a single corporation. Note, for example, that Section 202(b) of the Revenue Act of 1918 established an exemption from income taxation for the " . . . merger, or consolidation of a corporation." Such transactions obviously require the involvement of at least two (merger) or three (consolidation) corporations. Two corporations are also required to effect a change in domicile from one jurisdiction to another. (As stated in the introduction to this chapter, one of the principal issues in the post-1954 era prior to the amendment made to the Type F reorganization by the Tax Equity and Fiscal Responsibility Act of 1982 was whether or not combinations of commonly-owned corporations can fall within the definition of the Type F reorganization.) In his effort to persuade the courts not to expand the scope of the Type F reorganization so as to include such transactions, the Commissioner has pointed to this wording in the original definition as evidence of congressional intent to limit its application to adjustments involving only a single operating corporation. See discussion infra., pp. 401 to 405. Although " . . . of a corporation" was dropped from the Type F reorganization definition two years later in the Revenue Act of 1924, neither the Treasury Department, in recommending the change, nor the Congress, in legislating the change, intended any substantive change from the original definition.

In this regard, note also that the present-day United States Code (1 U.S.C. Sec. 1) establishes the following interpretative rule:

"In determining the meaning of any act or resolution of Congress, words importing the singular number may extend and be applied to several persons or things; . . . [and vice versa] . . . ."

But see Treasury Regulation 62, Article 1566(b) (1922), promulgated contemporaneously with the Revenue Act of 1921, which refer to the Type F reorganization as involving an "internal adjustment of the affairs of a corporation, . . . "

[62] Consider yet one more argument favoring liberal interpretation. In Randolph Paul, Studies in Federal Taxation, 3rd Series (Boston: Harvard University Press, 1940): 82, the author suggests that the economically unsound consequences which then accompanied transactions of the type presented in Marr v. U.S., 268 U.S. 536 (1925) (where the Supreme Court held that the reincorporation of General Motors in a different state with no change in its business operations or stock ownership was a fully taxable event) provided the inspiration for the Type F reorganization. (Although this case was not decided by the

Supreme Court until 1925, it was in dispute before the Bureau of Internal Revenue prior to the passage of the Revenue Act of 1921 on November 23, 1921. A.R.R. 289, 3 C.B. 57 (1920).) But if the Type F reorganization is to be literally construed, it is unlikely that the taxpayer in Marr would have been insulated from the recognition of gain even if the statute had been operational at the time the reincorporation took place. Indeed, the Court, in deciding the case for the government, stressed the significance of the fact that the old and new corporations were governed by the laws of different states:

> "In the case at bar, the new corporation is essentially different from the old. A corporation organized under the laws of Delaware does not have the same rights and powers as one organized under the laws of New Jersey. Because of these inherent differences . . . the stock of the old corporation is an essentially different thing from the stock . . . in the new." (at p. 541) (Emphasis supplied.)

To paraphrase: a change in the state of incorporation is not (or at least not always) a mere change. If Congress was indeed motivated to enact the Type F reorganization in response to Marr, then it must have intended the provision to cover such situations. Since a literal interpretation of the Type F reorganization definition would probably have failed to exempt the transaction (since the change of domicile is not "mere"), then such a restricted interpretation was probably not intended.

[63] A majority of cases have permitted the substitution of a word or phrase for those embodied in the statute where the substitution is necessary to carry out the intent of the legislature or to express a clearly manifested meaning. Murray v. Baker, 3 Wheat (16 U.S.) 541. 4 L.Ed. 454 (1818). Such "exceptional construction" is not judicial legislation, " . . . but is simply a method of arriving at legislative intent defectively expressed." Baca v. Bernalillo County Comm'rs., 10 NM 438, 62 P 979 (1900). In Ronson Patents Corp. v. Sparklets Devices, 102 F. Supp. 123 (D.C., 1951), the court permitted the substitution of one word for another where the word to be substituted could be gathered from the context of the act. "Exceptional construction" is a power which must be carefully employed: "It is always a dangerous business to fill the text of a statute from its purposes, and, although it is often unavoidable, it is utterly unwarranted unless the omission from, or corruption of, the test is plain." Harris v. Comm., 178 F.2d 861 (CA-2, 1949), at p. 864. Some courts oppose any such dabbling with the statute. DeSoto Securities Co. v. Comm., 235 F.2d 409 (CA-7, 1956).

[64] The Revenue Act of 1924 initiated the division of the reorganization into separate subparagraphs, each having its own alpabetical designation. The Type F reorganization definition was contained in Section 203(h)(1)(D) of the 1924 Act.

[65] See, for example, Brief for Appellant at p. 25-26, Home Construction Corp. v. U.S., 439 F.2d 1165 (CA-5, 1971).

[66]U.S., Congress, House, Committee on Ways and Means, House Report No. 179, accompanying H.R. 6715, 68th Congress, 1st Session, 1924, at p. 13; and U.S., Congress, Senate, Committee on Finance, Senate Report No. 398, accompanying H.R. 6715, 68th Congress, 1st Session, 1924, p. 14 See also U.S., Department of the Treasury, Statement of the Changes Made in the Revenue Act of 1921 by the Treasury Draft and Reasons Therefor, (1924), p. 5, prepared by the Treasury Department to accompany its proposed amendments to the 1921 Revenue Act (which were subsequently adopted in toto by the 68th Congress).

[67]Specifically, Sections 203(h)(1)(A) and (B) of the 1924 Act. (See pp. 53 to 56.)

[68]Section 203(h)(1)(D) of the Revenue Acts of 1924 and 1926; Section 112(i)(1)(D) of the Revenue Acts of 1928 and 1932; Section 112(g)(1)(E) of the Revenue Acts of 1934, 1936 and 1938; Section 112(g)(1)(F) of the Internal Revenue Code of 1939; and Section 368(a)(1)(F) of the Internal Revenue Code of 1954.

[69]See, for example, Burnet v. Sanford and Brooks Co., 282 U.S. 359 (1931).

[70]See also Jacob Merten, Law of Federal Income Taxation (Callaghan & Co.: Chicago): Section 3.34 ("Presumption Against Repeal by Implication").

> "Unless it is clear that a later statute should replace an earlier statute, effect, so far as possible, should be given both. Only in the case of a positive irreconcilable repugnancy will such implied repeal of the older act be presumed."

[71]U.S., Congress, Senate. Committee on Finance, Hearings on H.R. 8300. 83rd Congress, 2d Session (1954): 405. See also: Joseph M. McManus, "Judicial Law-Making: The Liquidation of a Corporation Treated as an F Reorganization," Journal of Corporate Taxation 2 (Autumn, 1975): 280 to 283; and Bercy Industries, Inc. v. Comm., 640 F.2d 1058 (CA-9, 1981).

[72]U.S., Congress, Senate, Committee on Finance, Hearings on H.R. 8300, 83rd Congress, 2d Session (1954): 404. The second situation (the liquidation of the wholly-owned subsidiary) was not expressly incorporated in the final statute. The courts have, of course, universally granted exemption from the carryback prohibition in such circumstances.

[73]Jacob Merten, Law of Federal Income Taxation (Callaghan & Co.: Chicago): Section 3.34.

[74]See, for example, Stauffer v. Comm., 403 F.2d 611 (CA-9, 1968), rev'g 48 T.C. 277 (1967); and Performance Systems, Inc. v. U.S., 382 F.Supp. 525 (D.C, 1973). aff'd per curiam 501 F.2d 1338 (CA-6, 1974).

[75]48 T.C. 277 (1967), rev'd 403 F.2d 611 (CA-9, 1968).

[76]But see Adam Smith's "canons of taxation" in The Wealth of Nations(1776), where a "good" tax system was said to be one which was "equitable," "convenient," "certain," and "economical."

[77]There are several different facets to the concept of equity as it pertains to taxation. In its purest form, horizontal equity, for example, mandates that equivalent tax treatment should be accorded similarly situated taxpayers, and that equivalent transactions should give rise to equivalent tax outcomes. The concept of "neutrality" is closely related to that of horizontal equity.

> "Neutrality" . . . refers to impartiality of treatment. Impartiality is lacking where essentially similar taxpayers [or transactions] are treated differently under the tax law or where the same tax treatment is accorded essentially different taxpayers or transactions. Partiality, where it exists, may be deliberate or it may arise as a result of congressional, administrative, or judicial oversight. To the extent taxing provisions depart from neutrality, for whatever reason, they become regulatory in that they determine the directions in which taxpayers may become wealthy or not. The resultant tax induced distortion of economic decisions can be justified only when supported by adequate public purpose and ample grounds for acheiving that purpose. (American Institute of Certified Public Accountants, Statement on Tax Policy #5: Taxation of the Formation and Combination of Business Enterprises (American Institute of Certified Public Accountants: New York, 1979): 5.)

The equity criterion also requires that every effort be made to minimize unintended tax traps for unwary which might otherwise result when different forms of economically equivalent or near-equivalent transactions give rise to materially different tax consequences.

[78]William H. Hoffman, ed., West's Federal Taxation: Individual Income Taxes, 1982 ed. (West Publishing Co.: St. Paul, 1981): 37-49.

[79]Ibid.

[80]See Burnet v. Sanford and Brooks Co., 282 U.S. 359 (1931).

[81]403 F.2d 611, at p. 616, discussed supra., pp. 391 to 413.

[82]Supra., note 77.

[83]One possible reason for merging commonly-owned operating

corporations would be to achieve operating efficiencies. (There are several reasons for initiating an integrated business by componentizing it in separate corporate shells (e.g., isolation of liabilities). Once the multiple corporations are no longer needed for these reasons, consolidation of these enterprises is often undertaken to achieve operating efficiencies. See, for example, Ltr. Rul. 7809084, Ltr. Rul. 7831013.)

See also Ltr. Rul. 7811070, where two subsidiaries of a parent bank holding company were merged in order to take advantage of state branch banking laws.

[84] As noted previously, this arbitrary prohibition can be expected to deny carrybacks to deserving corporations just when they need them the most: to generate the cash flow necessary to get the business back on the road to recovery or, in more extreme circumstances, to stave off financial ruin. In other areas the tax law, congress has recognized the desirability of accelerating refunds in circumstances where cash flow needs are great. (See, for example, Section 165(h), which allows a carryback of disaster area losses to the year preceeding the actual disaster as a means of providing needed funds to affected taxpayers.)

The denial of a net operating loss carryback is especially devestating where the corporation would otherwise qualify for an extended carryback period (e.g., financial institutions (10 year carryback per Section 172(b)(1)(F)), net operating losses resulting from product liability losses (10-year carryback per Section 172(b)(1)(H))).

[85] See, for example, Burnet v. Sanford and Brooks Co., 282 U.S. 359 (1931), and U.S. v. Lewis, 340 U.S. 590 (1951), where the Supreme Court sacrificed "equity" for "administrative" considerations.
Note that the stimulus for courts initial willingness to grant F status to multi-corporate F's was on equitable grounds. Even the Tax Court, which has consistently opposed this extension of the statutory definition, did so primarily on the grounds technical construction, not on the grounds that such an interpretation was necessary to the prevention of unwarranted tax avoidance. Nor did the Commissioner once argue that the extension of the Type F reorganization to multi-corporate transactions should be prevented on such grounds.

[86] Richard Crawford Pugh, "The F Reorganization: Reveille for a Sleeping Giant?" Tax Law Review 24 (May, 1969): 460.

While many acquisitions of loss corporations may be said to be motivated in whole or in part by the availability of existing net operating loss carryovers, how many corporations seek to acquire heretofor profitable corporations with a view to incurring sizable operating losses for the purpose of carrying them back to generate a

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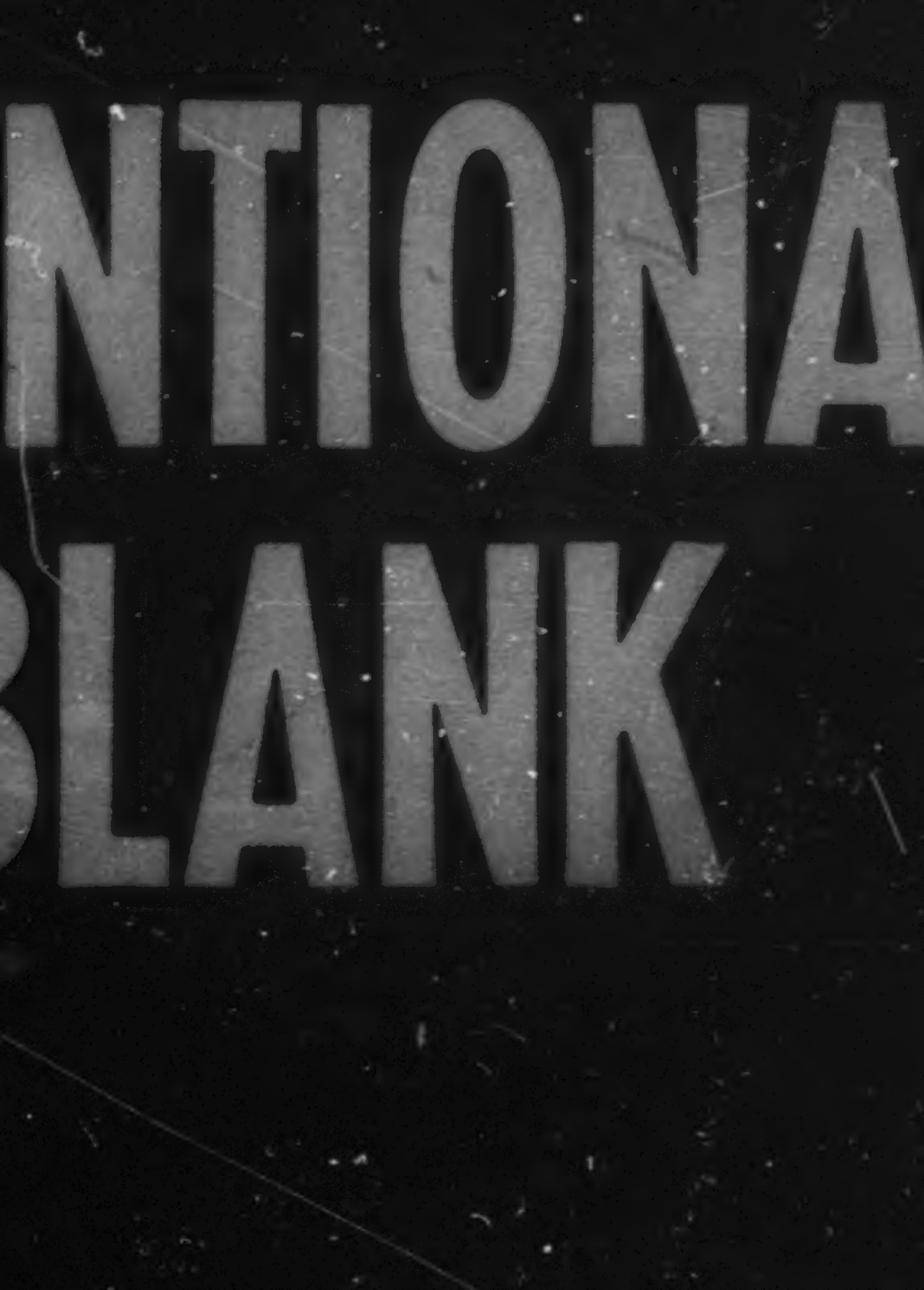
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refund from the transferor corporation's pre-merger taxes?!

[87] But see Section 382(a) and Section 269, each of which operates to reduce or eliminate the carryover of favorable tax attributes in certain acquisitions which are characterized by changes in ownership without a concommitant change in the corporate entity itself.

[88] Note that the same Congress which eliminated multi-corporate Type F reorganizations postponed effective date of new Section 382(a) which itself tolerates 60% change in ownership. New Section 382(a) likewise grants substantial continuing benefit of net operating loss carryforwards notwithstanding major changes in the identity of those who sustained economic detriment of the loss and those who will ultimately enjoy the tax benefit therefrom.

[89] Reg. Sec. 1.1502-79(a)(1)(ii).

[90] Assume that P Corporation, S Corporation and T Corporation are all calendar year corporations.

[91] Aetna Casualty and Surety Co. v. U.S., 568 F.2d 811 (CA-2, 1976). See discussion, Appendix I.

[92] Bercy Industries, Inc. v. Comm., 640 F.2d 1058 (CA-9, 1981). See discussion, Appendix II.

[93] An acquired corporation's "taxable income" for each "open" year would seem to be just as much a "tax attribute" of a corporation as its net operating loss, etc. carryforwards. Viewed thusly, one would expect that such attribute should carryover to the acquiring corporation subject to limitations similar to those applicable to all of the acquired corporation's other attributes.

FOOTNOTES TO APPENDICES I AND II

[1]568 F.2d 811 (CA-2, 1976), rev'g. 403 F. Supp. 498 (D.C., 1975).

[2]Under the Life Insurance Company Income Tax Act of 1959, the amount of taxes payable by life insurance companies was made to depend, in part, upon their asset base: the greater the value of its assets. the greater the company's taxes. One of Aetna Life's assets was the 61.61% stock interest it owned in "Old Aetna."

[3]Under Section 802(b)(3), a direct distribution of the Old Aetna stock to its shareholders would have triggered taxable income to Aetna Life.

[4]Recall that Section 381(b) does not grant exemption from the carryback prohibition of Section 381(b)(3) in Type C reorganizations.

[5]49 T.C. 32 (1967).

[6]315 U.S. 194 (1942).

[7]368 F.2d 125 (CA-5, 1966).

[8]1961-2 C.B. 62.

[9]403 F. Supp. 498, at pp. 512 to 513.

[10]But see Estate of Stauffer v. Comm., 403 F.2d 611 (CA-9, 1968), at p. 619, where the Ninth Circuit Court of Appeals held that the same definitive standards apply regardless of the issue under review.

[11]568 F.2d 811, at p. 822.

[12]Ibid., at p. 822. citing with approval Reef Corp. v. Comm., 368 F.2d 125 (CA-5, 1966), at p. 134.

[13]568 F.2d 811, at p. 821.

[14]Ibid., at p. 823.

[15]Ibid., at p. 824.

[16]70 T.C. 29 (1978), rev'd. 640 F.2d 1058 (CA-9, 1981).

[17]Ibid., at p. 40

[18]640 F.2d 1058, citing U.S., Congress, Senate. Committee on

Finance, Hearings on H.R. 8300, 83rd Congress, 2d Session (1954), p. 404.

[19] Jacob Mertens, Law of Federal Income Taxation, (Chicago: Callaghan & Co.): Section 3.29.

[20] But see N. B. H. Land Company, 78-1 USTC para. 9358 (D.C., 1978), which was decided before the Ninth Circuit rendered its decision in Bercy. Here, the transactional pattern was the same as that under review in Bercy with two differences: (1) the target corporation was acquired by an unaffiliated shell corporation, rather than by a shell subsidiary of an operating parent corporation, and (2) instead of using its stock to acquire the stock of the target corporation in a nontaxable reorganization, the acquiring corporation used cash, with the result that the transaction was fully taxable with respect to the selling target corporation shareholders. (A few days after the stock purchase, the target corporation was liquidated into the shell parent corporation under Section 332 / Section 334(b)(2) (pre-TEFRA'82).)

The presiding District Court judge refused to separate the purchase from the upstream merger so as to find the latter a Type F reorganization for the purposes of applying Section 381(b)(3). Under Southwest Consolidated, the 100% shift in interest to outsiders precluded the application of this reorganizational form for any purpose under the tax statute. This court did not consider the issue of whether the legislative intent behind Section 381(b)(3) might mandate a more favorable result to the taxpayer. Nor was the court influenced by the fact that the carryback would not have been precluded under the economically equivalent transaction of having the parent merge downstream into the subsidiary.

Although the acquisition in Bercy did constitute a nontaxable reorganization exchange (and the court did note, in passing, that there was some continuity of interest on the part of the Old Bercy shareholders) the reasoning of the Ninth Circuit Court in granting the carryback strongly suggests that it would have done so even if the acquisition had been fully taxable, as it was in N. B. H. Land Company.

[21] A 100% cash purchase of stock without any change in the corporate entity or in the nature of the business enterprise, for example, does not preclude the carryback of post-acquisition losses.

[22] 640 F.2d 1058, footnote 7, at p. 1062.

[23] "Finally, the Commissioner himself concedes that the loss carryback would have been permitted had Bercy reorganized pursuant to a reverse triangular merger, yet such a reorganization would have resulted in the same change in shareholder ownership which the Commissioner now argues should prevent the carryback." (Ibid., at p. 1062.)

[24] Ibid., at p. 1062.

Chairman RANGEL. Thank you.

You and your colleagues that do this research, besides the court decisions, what resources did you use to reach your conclusions?

Mr. LARUE. In examining the original intents and purposes behind the type F reorganization, I went all the way back to 1917, the first reorganization provisions under what was called the Excess Profits Act of 1917. I looked at the legislative history, the comments made on the House and Senate floors, committee reports, and so forth, to derive the fact that the type F reorganization, certainly before 1934, probably was intended to be a very broadly interpreted form of reorganization.

I also looked at the legislative history to section 381(b)(3), and then also at——

Chairman RANGEL. You talked with business people that are involved in these transactions?

Mr. LARUE. Actually, no, or at least not directly. I went back primarily on the basis of case law and the practical problems that revealed legislative history, and the belief that there are really no impediments to extending the carryback privilege to other forms of reorganization than are allowed under the current statute.

Chairman RANGEL. Mrs. Kennelly.

Mrs. KENNELLY. No questions.

Chairman RANGEL. We are joined by Mr. Duncan.

Mr. DUNCAN. I have no questions, Mr. Chairman.

Chairman RANGEL. If the panel would be kind enough, I would ask staff to prepare questions after we have gone through your testimony, to see whether we have missed any areas that we would need your expertise on, and we will keep the record open.

Mr. TOMASULO. Be glad to write answers.

Chairman RANGEL. Thank you.

[The following was subsequently received:]

SUPPLEMENTARY STATEMENT OF NICHOLAS TOMASULO

1. In a net operating loss statute the basic problem is differentiating between

(a) the good case, the acquisition of a going business, the tax losses of which are incidental, and

(b) the bad case, the mere acquisition of the charter of a loss corporation (which owns no business assets) solely to use such corporation's tax losses.

2. The bad case involves the sale of the business assets either before or after the transfer of the stock. Thus it is either

(a) an investment case, that is one in which the business assets are sold before (sometimes long before) the transfer of the stock and the proceeds are used to purchase investments, or

(b) an "Alprosa Watch"-type case, in which the loss corporation has business assets at the time of the transfer of the stock, but these assets are sold after such transfer.

3. Obviously any statute on the net operating losses, intended to prevent the sale of naked charter losses must have

(a) an anti-investment rule under which losses will not survive to the extent the loss corporation owns investments, but will survive to the extent it owns business assets, and

(b) an anti-Alprosa rule under which the amount of losses allowed or to be allowed will be diminished by the sale of business assets after the sale.

4. At the persent time, losses will generally not survive the transfer of stock in an Alprosa Watch-type case because of section 269 IRC 1954 (formerly section 129 IRC 1939) which denies such losses when the intent of the person acquiring a loss corporation is to avoid taxes. However, the Alprosa Watch-type case will become very important again if section 269 is repealed or modified. Therefore section 269 must be retained, unless some new test is substituted.

5. The Senate Finance Committee's proposed statute
(a) has a very weak anti-investment rule, and
(b) has no anti-Alprosa rule at all. [The Technical Committee report does suggest that if the sale of business assets is arranged before the stock transfer then the sale may be treated as made before such transfer. However, this too is very weak.]
6. If a statute like that now proposed by the Finance Committee is enacted, then advertisements to sell loss corporations will again appear in the Wall Street Journal and The New York Times, more or less as follows:
"For Sale: Loss corporation with $3,000,000 in recent tax losses. Now owns $1,000,000 in investment assets and $1,000,000 in business assets which can be readily sold after the purchase of the stock."
7. Generally similar advertisements have appeared in the past and the public perception has always been that they show conclusively that losses (not business assets) are being bought and sold. Indeed, it was largely because of the embarrassment over such ads that, before the 1954 Code, section 129 of the 1939 Code (now section 269 of the 1954 Code) was enacted.
8. Anyone who knows the political history of the issue will see at once that the passage of a statute which permits substantial manipulation will (like safe harbor leasing) result in enormous embarrassment to Congress and the Treasury.
9. For this reason, if it is not possible to say "no" to those who wish to create substantial opportunities for manipulation, it is much, much better to enact no statute at all for the present.

Chairman RANGEL. The next panel consists of the former Secretary of the Treasury, Donald Alexander, who is now with Cadwalader, Wickersham & Taft; James B. Lewis, chairman of the Section of Taxation of the American Bar Association; Mr. Robert Jacobs and Mr. Richard Loengard, who are from the New York State Bar Association Tax Section; and the American Institute of Certified Public Accountants, chairman of the section 382 task force, Paul Schecter.

Gentlemen, I recognize the restrictions of the 5-minute rule in terms of the long work that you have put into these documents, as relates to a very complex part of our Tax Code, but only the restrictions of time prevent me from allowing you to really expound as much as you should, and we would like for you to do. But if you could bear with the 5-minute rule, it will assist the Chair and, again, as I said with the other witnesses, all of you are deeply respected by the members of the Ways and Means Committee, and certainly most all of you have had a good working relationship with the staff. We need your input to make certain that we do not do worse than we did in 1976.

So rest assured that my request that you allow yourselves to respond to other questions that staff may have is not an empty one, but something that we really need, and of course, no one knows that better than Donald Alexander who has worked with us so well, both with the Government, and in the private sector. We thank you for taking time out, as you always do, in responding to our request for your expertise.

Mr. Secretary.

STATEMENT OF DONALD C. ALEXANDER, ESQ., PARTNER, CADWALADER, WICKERSHAM & TAFT, WASHINGTON, DC

Mr. ALEXANDER. Thank you for promoting me, Mr. Chairman. I appreciate that, and thank you for permitting me to be here.

Mr. Chairman, I have been working, as others at this table have, with the Senate Finance Committee staff on a basic revision of subchapter C of the code, and included in that revision is a revision of

section 382, and its companion provisions. A report has just been produced. I received it in the afternoon of the 20th, to late to include it in the very short statement that I have submitted to you.

That provides an approach that I hope the Ways and Means Committee will give very serious consideration to in your solution to this problem.

It is interesting to hear the Treasury talk about free transferability.

Chairman RANGEL. We have it. It has been circulated, but at least we know what you refer to.

Mr. ALEXANDER. As I say, it came out after I produced my short statement.

My short statement suggests that the staff approach on the Senate side is a sound approach, but it said I had considerable problems with its implementation. I am glad to see a number of problems have cleared up in the version that appeared on May 20, not all of them, but most of them.

It is interesting to hear the Treasury talk about free transferability of net operating losses and other tax benefits and refundability.

One of the questions I have always had, Mr. Chairman, is if you put such massive allowances in the tax law, why provide them only to the rich? Why not let the poor have them, too? What is wrong with free transferability?

Well, I suppose it cannot be passed, and so that is what is wrong with it. So let us move on to some questions that the preceding panel discussed.

Mr. Chairman, I know a lot about St. Bernards, and something about poodles, and something about Pekingese, and I never found one that knew the difference between an investment asset and business asset, and I think it is frequently very difficult to make that determination.

You can take easy cases like a company whose assets consist solely of stock in another corporation. Sure. That is probably investment, unless the company happens to be owned by T. Boone Pickens, and then it may be something else. But you do not have those cases in this real world, and I question seriously whether an investment limitation—there is one in the subchapter C proposal by the Senate staff—is worth maintaining.

The next point, Mr. Chairman: We heard from the preceding panel that a rate of return, some sort of limitation, might be undesirable, because the acquiring company applying the principle of neutrality cannot get more than 46 percent of the nominal value of the net operating loss carryover, and nobody is going to pay $1 to get 46 cents.

But, of course, if you look at what the acquired company was, and how it could use its carryovers, you have an entirely different picture. You should also consider that the acquired company had some assets other than the NOL; particularly if you adopt the attitude that investment assets might count, then you have another picture.

So we thought on the Senate side that a rate of return limitation made sense. The Senate staff proposed, in their latest draft, to use the Federal rate.

Finally, Mr. Chairman, I hope there will be a special rule for insolvent companies. I think the suggestion made by the prior panel is an excellent one, and there should be a special rule for those special circumstances.

Thank you.

[The prepared statement follows:]

STATEMENT OF DONALD C. ALEXANDER, CADWALADER, WICKERSHAM & TAFT, WASHINGTON, DC

My name is Donald C. Alexander and I am a partner in the Washington office of Cadwalader, Wickersham & Taft. I am testifying today in my personal capacity in support of a proposal developed by the staff of the Senate Finance Committee and the Finance Committee Subchapter C Working Group, of which I am a member, to effect a badly needed overhaul of the rules governing tax attribute transmission.

The problems with and history of the complex 1976 amendments to Code Section 382 are well known and need no recounting, and old (but still current) Section 382 both overshoots and misses the mark. Suffice it to say that the time for stop-gap measures is past, and that improvements and certainty in this area would be in the best interests of taxpayers and the Treasury alike.

While not perfect in the form in which I last reviewed it, the Staff's proposed revision of Section 382 represents a marked improvement over either current law or the 1976 amendments, now scheduled to take effect January 1, 1986. The ABA Tax Section's proposal represents a similar improvement. My endorsement of the thrust of the Staff's proposal does not represent support for all its facets and limitations. In certain respects it is (or was) overly restrictive and complex. Under the Staff's proposal as I understand it, the net operating losses (NOLs) and recognized built-in losses of an acquired corporation attributable to the period prior to a "triggering" event (these losses would be referred to as "pre-trigger" losses) could be used by the acquiring corporation to offset taxable income for any "post-trigger" year only to the extent of a so-called "pool of capital limitation" for such year. The pool of capital limitation for a post-trigger year would be a specified percentage of the value of the loss corporation immediately prior to the triggering event, plus any recognized built-in gain for the taxable year. Any unused limitation for a post-trigger taxable year could be carried over and added to the next year's limitation. The so-called "trigger value" of the loss corporation upon which the pool of capital limitation would be based would generally be equal to the value of the stock immediately before the triggering event, subject to reduction for capital contributions made as part of a plan to increase the value of an acquired corporation.

In short, the loss limitation would be a prescribed rate of return times the value of the loss corporation immediately before the trigger event. The Treasury would be directed to determine and publish rates of return annually and the rate of return in effect at the time of acquisition would apply in determining the pool of capital limitation for all post-trigger years.

The new rules are designed to apply in the case of any substantial (more than 50%) change in ownership, whether effected by a stock or asset acquisition, with certain exceptions for nonabusive situations, particularly shifts in ownership incident to divorce or separation or changes in proportionate ownership of stock attributable solely to market fluctuations.

Finally, under the draft proposal, pre-trigger tax credits could be used to offset post-trigger tax liability, but only to the extent that the pool of capital limitation for the post-trigger year in question exceeds the amount of pre-trigger loss taken into account in determining the taxable income for such year. Also, the Treasury would be directed to prescribe rules respecting the treatment of net capital losses. To round out the statutory scheme, Section 269 (relating to acquisition made to evade or avoid income tax) would be made expressly inapplicable to transactions to which the new Section 382 rules apply, so as to avoid overlap.

As I have stated, I question the need for certain specific limitations in the draft, and the simpler ABA approach may be preferable in certain respects. But the principle of neutrality is sound. A basic difference in the size of the allowance results from different assumptions about utilization of losses.

The new rules are intended to limit the amount of pre-trigger NOLs that can be used to offset post-trigger taxable income to an amount approximating the taxable income the loss corporation would have had if the change of control had not occurred. Thus, the value of NOLs to the acquiring corporation should be no greater

than to the loss corporation and there should be less incentive to make uneconomic acquisitions motivated solely by the prospect of realizing tax benefits.

The principal advantage of this approach over both existing law and the 1976 amendments is that it more accurately targets the remedy to the problem. Current law takes an all-or-nothing approach to taxable acquisitions: if there is a substantial (more than 50%) change in stock ownership over a two year period, loss carryovers from pre-acquisition years are allowed in full if the acquiring corporation continues the trade or business of the loss corporation, but if it does not the NOLs are lost altogether. In the case of a tax-free reorganization, continuity of the business of the loss corporation is immaterial: loss carryovers are allowed in full if the former stockholders of the loss corporation receive 20% or more of the value of the stock of the acquiring corporation, and for each percentage point less than 20 the former stockholders receive, the loss carryover is reduced by 5 percentage points.

In addition to the administrative difficulty of applying the continuity of business rule and the conceptual fragility of the distinction between taxable and tax-free acquisitions, the current rules may be as likely to penalize transactions motivated by sound economic considerations as to curb trafficking in tax attributes. While the postponed 1976 Act amendments scheduled to take effect next year would, at the cost of much complexity, make some improvements (the treatment of taxable and tax-free acquisitions would be equalized and the awkward continuity of business rule would be eliminated), the new scheme, like the old, is basically flawed, for the allowance or disallowance of NOLs to the acquiring corporation may bear no relationship to the utilization of the losses by the acquired corporation. Moreover, uncertainty in planning transactions would continue, for an acquisition that has successfully run the gauntlet of Section 382 may still be subject to the loss-limitation provision of Section 269.

Although in the form I last saw it, the Senate Finance Staff's proposal is hardly simple (complexity may be inevitable in this area) and in need of change to ease certain restrictions, it is, in my view, likely to be more easily administrable than either existing Section 382 or its scheduled successor, and to produce more rational results. As modified, the proposal, like that of the ABA Tax Section, is a long step in the right direction.

Chairman RANGEL. Thank you.

Mr. Lewis, chairman of the Section of Taxation of the American Bar.

STATEMENT OF JAMES B. LEWIS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, ACCOMPANIED BY ROBERT A. JACOBS, CHAIRMAN, COMMITTEE ON CORPORATE SHAREHOLDER RELATIONSHIPS

Mr. LEWIS. Mr. Chairman, I appear for the American Bar Association, which has adopted resolutions which are attached to my prepared statement. You will find attached to my prepared statement not only those resolutions, but proposed statutory language, which is in clean form for introduction in the House, and an accompanying discussion that would form the basis for a committee report.

The advantage that we are bringing to you, that no previous spokesman, and I think no subsequent one will bring, is actual statutory language, and let me speak to that language.

It is consistent in approach with what the Treasury recommends, in that it invokes the principle of neutrality. It allows to the new owners the amount of loss that you would suppose the old owners would have been able to utilize considering the amount of their assets. It is the purchase price approach. One rule would apply for all kinds of acquisitions. It is consistent with the recommendations that Richard Bacon urged to you. It is consistent with Mr. Ellingson's proposals. It is consistent with the Senate Finance Committee staff's subchapter C proposals.

It is consistent with what Donald Alexander has proposed.

Chairman RANGEL. How do you handle the passive assets of the loss corporation?

Mr. LEWIS. We agree with Donald Alexander, that you cannot distinguish passive assets from business assets. Working capital may be in the form of cash, it may be temporarily in the form of United States Steel stock, simply because the cash itself is not income productive.

I do not think the distinction between so-called passive assets and active assets is a workable rule. Assets are assets. But to prevent abuse, we have an antistuffing rule, which looks back 2 years, and says that if the passive assets have been shoved in in order to make the loss company worth more, then you disregard them. That is simple. It is mechanical, and it will work.

I urge you to recommend to your parent body that this draft be considered for introduction, for hearings, because then you would have hearings that are addressed to particular proposed rules which would be much more constructive, and get you on the fast track.

That is all I have to say.

Thank you.

[The prepared statement follows:]

STATEMENT OF JAMES B. LEWIS, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

SUMMARY

I am James B. Lewis, Chairman of the Section of Taxation of the American Bar Association. I appear today to state the position of the American Bar Association concerning the proposed revision of Internal Revenue Code section 382, which governs carryovers of net operating losses and other tax attributes following certain corporate transactions. The American Bar Association's views are embodied in a Legislative Recommendation approved by the House of Delegates in February (the "ABA Recommendation"), a copy of which is annexed to my prepared statement.

Present law reflects the Congressional policy that net operating losses and other tax benefits should not be freely transferable in the marketplace. The problem with present law is that it does not implement that policy well. Under some provisions of present law, continuation of the corporation's business is crucial, while under others it is not. Different rules exist for taxable and taxfree acquisitions. Sometimes motive is important and sometimes it is not. Some provisions work on an all or nothing basis and others on a sliding scale.

What is needed is a fairer, more uniform, and conceptually justifiable approach. In our opinion, the ABA Recommendation meets those requirements. It builds on, and is consistent in theory with, proposals made by other groups—a 1958 Advisory Group to the House Ways and Means Committee, an American Law Institute proposal made in 1982, and a Senate Finance Committee staff proposal released in 1983.

The guiding principle utilized by the ABA Recommendation in limiting the carryover of operating losses and other tax attributes from seller to purchaser is that of "neutrality". Under that principle, the value of the carryovers of losses and other tax attributes should be the same in the hands of the purchaser as in the hands of the seller. The change in ownership should neither enhance nor diminish the value of the tax attributes.

The ABA Recommendation suffers from none of the defects of present law. Motive and the need for business continuity would become irrelevant. Taxable and taxfree acquisitions would be treated alike. The "all or nothing" approach would be eliminated.

The formula employed by the ABA Recommendation is that, following the change in control, the losses of the loss corporation can be deducted up to 24 percent of the purchase price in each of the succeeding five years. This would make purchase of a shell corporation having only losses economically unattractive. On the other hand, if

the loss company has assets that can produce income against which its losses can be taken the losses would become available to the purchaser in an amount corresponding to their value to the loss company.

The ABA Recommendation has been put into statutory language, which could easily be converted to bill form. It is accompanied by a report that could form the basis for a committee report. We urge that you recommend to the Ways and Means Committee that a bill based on the ABA Recommendation be promptly introduced.

Thank you for inviting me to testify for the ABA on this important matter.

STATEMENT

I am James B. Lewis, Chairman of the Section of Taxation of the American Bar Association. I appear today to express the views of the American Bar Association concerning the proposed revision of Internal Revenue Code section 382. That provision governs the utilization of tax attribute carryovers following certain corporate transactions. The views I express today are embodied in a Legislative Recommendation adopted by the Association in February 1985, (the "ABA Recommendation"), a copy of which is annexed.

PROBLEMS OF PRESENT LAW

Present law reflects the Congressional policy that net operating losses and other tax benefits should not be freely transferable in the marketplace. The problem with present law is that it does not implement that policy well. Under some provisions of present law, continuation of the corporation's business is crucial, while under others it is not. Different rules exist for taxable and taxfree acquisitions. Sometimes motive is important and sometimes it is not. Some provisions work on an all or nothing basis and others on a sliding scale.

Present section 382, enacted in 1954, does not work well. Congress has wisely prevented the "new section 382" (the 1976 revision of section 382) from becoming effective. The series of postponements have left the unsatisfactory 1954 rules in operation. The time to find a permanent solution is overdue.

Before turning to our recommendation, we should take another look at why we are here. Suppose that P (purchaser) corporation desires to purchase L (loss) corporation. L has $100 of operating business assets and $10,000 of net operating loss carryovers. Under present law (assuming the non-applicability of Code section 269 and consolidated return regulations limitations), if P pays $150 to purchase all the L stock and continues to operate L's historical business, P might be able to utilize all $10,000 of L's losses against P's otherwise taxable profits. This may be so even though L, were it to continue to operate its business and to achieve an annual return of 20% on its business assets, would be able to utilize only $20 a year of its loss carryovers, until they expired. With a maximum 15-year life for those carryovers, at best L could expect to utilize only $300 of the loss. Yet, existing law might permit P to utilize the entire $10,000 of the loss, and even to do so in the first year. That is not a proper result.

New section 382 would perform its mischief in a different way. Aside from introducing some unfathomable provisions and great complexities,[1] new section 382 manages to run twice as long as present section 382 without any recognizable improvement. There is a wide consensus that the 1976 revisions to section 382 should never take effect, if only because of their inordinate length and complexity.[2]

Suppose P purchases all the L stock for $10,000 at a time when L has business assets with a value of $9,900 and net operating loss carryovers of $200. Suppose, further, for simplicity of purposes, that the effective tax rates of both L and P are 50%. New section 382 would deny any net operating loss carryover utilization by L or P following P's purchase of L's stock. In this situation, new section 382 would create a

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[1] "The cause of simplification took a heavy beating in the new law, parts of which never may be subject to rational interpretation, let along intelligible exposition by regulations. While the corporate changes in the new law do not take highest honors in the complexity sweepstakes, there are parts of new section 382 that at least deserve honorable mention for legislative obfuscation. One can readily concede that it is probably far easier to criticize draft results than to personally perform that thankless task, but few would deny that substantial improvement is possible, even imperative, in this critical area." Eustice, "The Tax Reform Act of 1976: Loss Carryovers and other Corporate Changes," 32 Tax L. Rev. 113, 114, (1977) (footnote omitted).

[2] See, e.g., New York State Bar Association, Tax Section, "Report on Section 382 of the Internal Revenue Code as enacted by the Tax Reform Act of 1976," 31 Tax L. 283, 284 (1978). ("We would suggest that doubling the length of a Code provision probably leads to a fourfold increase in the problems in its interpretation.")

lock-in effect, because the value of the business (or more specifically, L corporation) would be greater to the present L shareholders by virtue of L's tax attributes than would the value of that same business in the hands of P. There can be little reason for denying net operating loss utilization to the transferee to the extent that utilization would have been available to the transferer. Yet that is precisely what new section 382 does—looking as it does solely to the transfer of control, without regard to any other feature of the transaction.

THE ABA RECOMMENDATION

Given the findings that neither present section 382 nor new section 382 works well, the American Bar Association has sought to develop a better and fairer rule.

The ABA Recommendation uses as the guiding principle to limit the carryover of tax attributes the concept of "neutrality." Neutrality, in this context, simply means that the value of the attributes in the hands of the purchaser should approximate their value in the hands of the seller. The change in ownership should neither enhance nor diminish the value of the tax attributes.

The ABA Recommendation suffers from none of the defects of present law. Motive and the need for business continuity would become irrelevant. Taxable and taxfree acquisitions would be treated alike. The "all or nothing" approach would be eliminated.

The formula employed by the ABA Recommendation is that, following the change in control, the losses of the loss corporation can be deducted up to 24 percent of the purchase price in each of the succeeding five years. This would make purchase of a shell corporation having only losses economically unattractive. On the other hand, if the loss company has assets that can produce income against which its losses can be taken the losses would become available to the purchaser in an amount corresponding to their value to the loss company.

Far too many people of significant talent have spent too many hours working on this problem, without devising a perfect solution. While the ABA Recommendation may be a less than perfect answer to all the situations that can arise in our complex corporate society, only incorrigible optimists can continue to say that a perfect solution could be developed if we were given a little more time.

THE DEVELOPMENT OF THE ABA RECOMMENDATION

The ABA Recommendation draws upon the earlier efforts described below.

The advisory group

An Advisory Group to the House Ways and Means Committee recommended in 1958 that, after a change in corporate ownership, an amount equal to 50% of the purchase price paid for the loss corporation should be used as loss carryovers.[3] Both taxable and non-taxable acquisitions would have been subject to the same rule. The Advisory Group proposal also contained an "anti-stuffing" rule that reduced the deemed purchase price by the value of any assets contributed to the loss corporation within six months before the acquisition.

The ALI proposal

In 1982 the American Law Institute proposed that the neutrality principle serve as the basis for effecting meaningful change in the loss carryover provisions.[4] The ALI Draft created two sets of rules—(i) a "merger" rule for transactions in which the loss company was acquired with the purchasing company's stock; and (ii) a "purchase" rule for stock purchases and other transactions that could not be accommodated under the "merger" rule.

Senate Finance Committee staff study

In 1983 the Staff of the Senate Finance Committee published its report (the "SFC Draft") on the Reform and Simplification of the Income Taxation of Corporations.[5] Under the SFC Draft both a purchase rule and a merger rule were formulated. An assumed rate of return on the loss corporation's business assets would be available to be offset by the loss corporation's carryovers. At the heart of the SFC Draft was the neutrality principle.

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[3] See hearings before the House Ways and Means Committee on Advisory Group Recommendations on Subchapters C, K and J of the Code, 86th Cong., 1st Sess. (1959).

[4] American Law Institute, Federal Income Tax Project—Subchapter C—Proposals on Corporation Acquisitions and Dispositions and Reporter's Study on Corporation Distributions (1982).

[5] 98th Cong., 1st Sess. 41 (Comm Print 1983).

The NYSBA proposal

The New York State Bar Association Tax Section recently recommended an alternative version of the purchase price limitation on loss carryovers. That Tax Section suggested limiting the allowable losses in each post-acquisition year to 20% of the total losses and recognized the propriety of permitting additional allowances to compensate for the resulting deferral of deductions.

An emerging amalgam

The ABA Recommendation borrows heavily from the teachings of these studies. Adopting the neutrality principle as its central theme, the ABA Recommendation seeks to combine the best of earlier studies with realistic marketplace applications. The ABA Recommendation follows the format suggested by the 1958 Advisory Group in measuring the available loss carryover by reference to the purchase price of the loss corporation. The 50% purchase price limitation suggested by the Advisory Group has been changed to an amount equal to 100% of the present value of the purchase price—spread over 60 months—to better comport with notions of fairness and economic reality. The neutrality principle espoused by the ALI is the centerpiece of the ABA Recommendation. But we reject the potentially theoretical improvement that might be achieved by forging a statute that would provide a "purchase" rule for some acquisitions, a "merger" rule for other acquisitions, and a "part-purchase/part-merger" rule for yet other acquisitions. Instead, we favor use of the less complex purchase rule for all types of acquisitions.

While we might spend our time discussing the differences in the approaches taken by the various groups which have studied this problem, the important feature is to note how similar—not how different—they are. Employing a purchase price criterion to establish loss carryover utilization and effecting neutrality through a single purchase price rule are central features of a rational Code section 382. All of the proposals recognize the need to deal with problems of built-in gain and loss, artificial augmentation of purchase price and consequent artificial augmentation of loss carryover utilization, and the desirability of certainty so that sellers can, at last, be fairly compensated for the tax attributes they transfer to buyers. That certainly requires that the vagaries and uncertainties of Code section 269 not play a role in transactions governed by section 382.

We urge that the Ways and Means Committee consider introduction of a bill based on the ABA Recommendation. We recommend the ABA Recommendation as a solution, not out of pride of authorship, but rather because the work that went into crafting that proposed legislation cannot readily be equaled by a crash drafting project.

ABA RECOMMENDATION FEATURES

The 5-year utilization formula

The ABA Recommendation provides for utilization of loss carryovers and other tax attributes (we label them "section 382 attributes") in an amount equal to 2%, times the number of months (up to 60 months) following a change of control. In other words, P would be entitled to deduct up to 24% of the purchase price of L each year for five years following a change of control. That 120% of purchase price formula, when reduced to present values, approximates 100% of the purchase price. We incorporated this feature, rather than permitting an immediate utilization of losses equal to 100% of the purchase price, so that large potential purchasers who could use all the losses immediately would not be favored over smaller prospective purchasers who could not do so. The ALI and SFC proposals would pursue a somewhat different approach, an approach which more closely tracks the theoretical neutrality base. They would permit an annual utilization of purchase price equal to an assumed earnings return on L's business assets, e.g., 12%. Those earnings base formulations are derived either from historical earnings of loss companies or from a hypothetical sale of L's assets and a reinvestment of those sales proceeds in high interest bearing United States government securities. The ABA Recommendation is, in this instance, more practical than theoretical. While the ALI and SFC recommendations would assume a loss carryover utilization period of up to 15 years (the present maximum loss carryover term), over experience is that business people seldom, if ever, place significant value on potential loss carryover utilizations against income 9, 11, or 13 years out. For this reason we propose that L's expectations of being able to utilize losses over a period of up to 15 years be equated through preset value assumptions to P's 5-year business analysis. Moreover, we have assumed that P, as most other business people, would not purchase L with a view to realizing a United States bond rate of return on its investment, but rather

would be anticipating a return of not less than 20%. That statistically such returns may not be realized does not detract from the validity of the observation that no business risks capital in a venture that is expected to produce returns just equal to that of secure United States government bonds.

Change of control

The ABA Recommendation defines a change in control that triggers the application of section 382 by reference to a transaction or integrated series of transactions that reduce the equity participation of old owners of the loss corporation by 50 percentage points or more. A number of transactions where equity interests are transferred are disregarded. The principal group of disregarded transfers are transfers where both the transferer and the transferee own less than 5% of the loss corporation. Other exceptions apply to transfers made pursuant to divorce, transfers, made among family members, whether during lifetime or at death, and transfers to creditors under carefully prescribed circumstances.

Under the ABA Recommendation, section 382 is triggered when there is a transfer or integrated series of transfers effecting a 50 percent change in equity ownership. There is no specific time frame during which transfers are to be measured. We recognize that this rule introduces some uncertainty. Other proposals use a specified time frame for measuring transfers, whether or not those transfers are effected pursuant to a plan, e.g., two years or three years. Those proposals also introduce uncertainty because the purchaser of a 45% interest in a loss corporation may have not control over unrelated transfers, e.g., a 10% sale by one party unrelated to P to another party unrelated to P. That type of uncertainty could thwart the ability of good faith buyers and sellers to achieve a fair price for the sale of stock compromising less than 50% of the interest of a target corporation

Investment assets

The neutrality principle would not distinguish among the assets owned by the loss corporation. If the loss corporation owned $1 million of Government securities yielding 12% per annum or business assets with a value of $1 million yielding 12% or some other return per annum, the purchase price for the loss corporation should be the sole criterion for determining the amount and rate of loss utilization. For this reason, and in recognition of the difficulty that would be encountered in distinguishing between business assets and investment assets, the ABA Recommendation applies the purchase price rule without regard to the composition of L's assets. Critics may question the propriety of enabling the purchaser of a corporation that has no assets, other than investment assets and loss carryover attributes, to convey those attributes to a purchaser. If you decide to require that investment assets not exceed a prescribed percentage of the loss corporation's assets to gain any section 382 attribute carryovers, I urge that the legislative history make clear that there is no requirement for the non-investment assets to be held for a prescribed period of time either before or after the change of control and that business assets to broadly defined for these purposes. For example, net leased real or personal property, ownership of oil wells or other mineral properties, working capital, and stock interests in operating companies constituting 20% or more of the value of the owned corporation should be treated as business, rather than investment, assets.

Anti-stuffing provision

The loss corporation's value should not be permitted to be artificially augmented by permitting the owners of the loss corporation to "stuff" the loss corporation with assets in anticipation of its sale. The ABA Recommendation reduces the deemed purchase price of the loss corporation by an amount equal to contributions made to the corporation within two years of the change in control (or otherwise in anticipation of the change). Where contributions are made to fund current losses of the corporation, or are otherwise made in the ordinary course of the target's business, and not in anticipation of its sale, they will not reduce the deemed purchase price.

Debt

Frequently loss corporations are capitalized or encumbered with debt. In determining the purchase price, the ABA Recommendation would permit the inclusion of any amounts paid for the loss corporation's debt, provided the debt was "old and cold," *i.e.*, more than two years old on the date of the change in control and provided further that the debt is converted into equity either prior to the change in control or promptly thereafter. The two year requirement is necessary to preserve the integrity of the "anti-stuffing" rule. The proposed treatment of debt recognizes that amounts paid for both debt and equity are appropriate ingredients in measuring the

total purchase prices of the loss corporation. Adoption of the ABA Recommendation approach to "old and cold" debt avoids the need to distinguish between acqusitions of troubled corporations that have filed under title 11 and troubled corporations that have worked out informal arrangements to reorganize themselves without the attendant delays and costs of formal bankruptcy court proceedings.

Ailing thrift institutions

Present law (Code section 382(b)(7)) provides special rules for carrying over net operating losses of ailing savings and loan associations and thrift institutions. In a typical takeover of a Federal Home Loan Bank Board regulated savings institution, the acquirer is required to infuse a minimum stipulated amount of capital into the acquired thrift. Under the ABA Recommendation that infusion would be deemed a part (or all) of the purchase price and the operative formula would be applied accordingly. Presumably, that would be the case under alternative proposals. In all events, the application of section 382 to these transactions should be made specific.

CONCLUSION

I am pleased to have this opportunity to appear before you today to express the views of the American Bar Association. Thousands of hours have been spent by our members studying and analyzing the policy and practical questions that the issue of section 382 attributes presents. Together with the other organizations, committees, advisory groups, and congressional staffs, we have worked to develop a coherent set of rules that would vastly improve existing law and fairly treat the three interested parties in transactions we have described—buyers, sellers, and the Treasury. We would be pleased to continue our work with you and you staff to enact a statute based on the ABA Recommendation. After these many years of study and reflection, we are persuaded that the time for a permanent solution has come. We urge you not to extend once again the operation of a statute that ill suits its intended purpose and that does not fairly balance the interests of buyers, sellers, and the Government.

The ABA Recommendation has been put into statutory language, which could easily be converted to bill form. It is accompanied by a report that could form the basis for a committee report. We urge that you recommend to the Ways and Means Committee that a bill based on the ABA Recommendation be promptly introduced.

Thank you for inviting me to testify for the ABA on this important matter.

COMMITTEE ON CORPORATE STOCKHOLDER RELATIONSHIPS
LEGISLATIVE RECOMMENDATION NO. 1985-1

TO AMEND THE INTERNAL REVENUE CODE OF 1954 TO PROVIDE THAT, FOLLOWING A CHANGE IN THE CONTROL OF A CORPORATION, ITS FAVORABLE TAX ATTRIBUTES SHALL BE LIMITED BY REFERENCE TO THE CORPORATION'S VALUE, AS EVIDENCED BY THE PURCHASE PRICE.*

RESOLVED that the following Resolutions be submitted by the Section of Taxation to the House of Delegates of the American Bar Association:

RESOLUTIONS

RESOLVED that the American Bar Association recommends to the Congress that the Internal Revenue Code of 1954 be amended to provide exclusive limitations for net operating loss carryovers and built-in ordinary losses, capital loss carryovers and built-in capital losses, and credit carryovers following a change in control of the corporation; that the corporate tax attributes be limited to a gradually increasing percentage of the corporation's value prior to the change in control;

FURTHER RESOLVED that the Section of Taxation is authorized to urge on the proper committees of the Congress amendments that will achieve the foregoing results.

REPORT

Summary

Under present law, three Code sections determine when and to what extent loss and tax credit carryovers may be utilized following a substantial shift in a target corporation's ownership: sections 269, 382, and 383. These provisions are not consistent in their approach or in their results. Under some statutory provisions, continuation of the corporation's business may be crucial, while under others it is irrelevant; different rules are provided for "taxable" and "tax-free" acquisitions; sometimes motives are important and sometimes they are not; and some sections provide measured reductions in attribute continuation, while others require their complete elimination.

*The Section of Taxation and the ABA House of Delegates approved the Resolutions on lines 16-29 above. The accompanying Report and Suggested Statutory Language were developed by the Section's Committee on Corporate Stockholder Relationships and reviewed by the Section's Council.

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No reason justifies these differences. Taxpayers have difficulty planning their transactions, while the Internal Revenue Service and the courts have difficulty in applying rules to consummated transactions. The irrational and uncertain application of the tax attribute carryover provisions permits purchasers to demand and receive deep discounts from the value of the purchased tax attributes at a large cost to the sellers and at an even greater cost to the fisc.

America's business community would benefit substantially if the rules governing tax attribute transmission could be clarified, with certainty. Lack of certainty deters transactions, penalizing both buyers and sellers, but punishing most heavily smaller corporations. Where large, publicly-held target corporations have been followed with envious eyes, and where the path to acquisition is illuminated by required public filings, there is more time and information available for legal considerations and solutions. With smaller corporate entities, these procedures simply do not get off the ground. Less time for consideration, less opportunity for planning and the specter of uncertainty of result cause many small corporations to lose survival opportunities. They succumb to financial chaos; their viability is destroyed; their payrolls are lost to their communities; and their stockholders suffer the resulting losses. Clarification and certainty of tax attribute transmission can be a saving and reviving force. By enacting the legislation urged in the Recommendation, Congress can help rescue many worthwhile enterprises, restoring their viability and marketability.

It is recommended that, following a change in the control of a corporation, certain of its tax attributes be limited by reference to the corporation's value when the change in control is effected.

Discussion

A consensus has begun to form in support of a rationale to limit tax attribute carryovers. The principle that attribute limitations should neither enhance nor diminish the value of the attributes has become known as the "neutrality principle," and is the foundation of the Recommendation, providing a single rule for all "qualified" stock and asset acquisitions -- whether effected by taxable or tax-free transactions.

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The neutrality principle, as embodied in the Recommendation, would not permit the "free trading" of tax attributes. Free trading would permit a corporation to transfer freely its beneficial tax attributes, either by themselves or as part of a transfer of the corporation's stock, without any limitation or restriction on the purchaser's use of those attributes. Free trading would permit sellers of attributes who could not use them, or who could use them only slowly, to realize greater value on their sale to purchasers who could use more of them, or use them more rapidly than if the corporation used them itself. In this respect, free trading is analogous to safe harbor leasing, a tax attribute transfer procedure expressly designed to permit owners of tax attributes to sell them to buyers who could make greater use of them. In sharp contrast, the neutrality principle and this Recommendation are designed to approximate and preserve the value of the tax attributes as they exist in the hands of the seller -- without enhancement or diminution -- in the hands of the buyer. Thus, tax attributes may be negotiated for a price, provided the attributes are incident to an acquisition of income producing assets.

Ideally, a statute embodying the neutrality principle would provide merely that, following a change in control of a target corporation, the corporation's attributes would be usable only to the extent that they would have been used had the change not occurred. Because that use cannot be ascertained or described with certainty, the Recommendation instead develops a formula to approximate the degree of tax attribute utilization that would have occurred had the change in control not occurred. Under that formulation, the purchaser's utilization of the target corporation's section 382 tax attributes would not be limited to income generated by assets owned by the target corporation prior to the change in control. The purchaser may use the section 382 tax attributes to offset the income generated from the target corporation's assets, the purchaser corporation's assets or newly acquired assets. The Recommendation would permit pre-change attributes to be used after the change in control in an amount equal to two percent of the purchase price each month for 60 months. These rules would apply equally to taxable and tax-free acquisitions of stock and to tax-free acquisitions of assets.

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Under the Recommendation — after certain assumptions concerning present-value computations are applied[1] — the following results would flow from transactions involving the purchase of all the stock of a loss corporation with net operating loss carryovers:

L's Income Producing Assets	L's Net Operating Loss Carryover	P's Purchase Price	Available NOL After Change in Control
1,000	100	1,042	100
1,000	1,000	1,381	1,000
1,000	10,000	1,720	2,064.

The Recommendation assumes that the value of a corporation (as determined by an arm's length purchase of, or another transaction in, its stock or its assets) reasonably measures the target corporation's future earning power and hence its ability to use its "section 382 attributes," i.e., its loss and tax credit carryovers and built-in losses. In many situations, the change in control transaction itself will involve a price or prices that will make the target corporation's value fairly readily ascertainable.

The purchase price paid for a target corporation may be allocated between its income earning assets and the value of its favorable tax attributes. With assumed interest, income earning, marginal tax, and tax benefit utilization rates, an algebraic formula can divide the purchase price between the income earning assets and the favorable tax attributes. Under the Recommendation, the present value of those favorable tax attributes (spread over five years) in the hands of the purchaser will equal the present value of those same attributes to the target corporation (spread over 15 years).

Simple examples involving acquired corporations that have net operating loss carryovers illustrate the conceptual link between purchase price and tax attribute utilization and demonstrate the effectiveness of a limitation based on purchase price. In these examples, the target corporation is permitted

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1 In the table, a discount rate of 10 percent has been used and the purchaser is presumed to fully utilize the net operating loss carryover within five years.

to use its loss carryovers only to the extent of 120 percent of the purchase price, to be used no more rapidly than at the rate of 2 percent of the purchase price each month for 60 months, commencing with the month during which the change in control occurs.

Assume L corporation has a net operating loss carryover of $15,000,000 and income producing assets worth $5,000,000. On these facts, we might estimate that L would earn 20 percent on its income producing assets or $1,000,000 per year, against which no tax would be exacted for 15 years. The present value of the anticipated tax savings, computed at a discount rate of 10 percent, is approximately $3,500,000.[2] Thus viewed, L has a value of roughly $8,500,000 to its present owners. If P pays $8,500,000 to purchase all the L stock, and if P uses L's carryovers at the rate of 2 percent of the purchase price each month for the 60 months following the purchase ($10,200,000 of loss carryover utilization over 60 months), the present value of P's post acquisition tax savings will be approximately $3,500,000 — the same present value calculated for L. Under these circumstances neither P, nor L, nor the Government stands to gain or lose from the transaction.

All other facts being the same, if L had a net operating loss carryover of $50,000,000 instead of $15,000,000, L would be expected to be able to utilize only $15,000,000 of its loss carryover, achieving tax savings having a present value of $3,500,000. Under the neutrality principle, embodied in the Recommendation, the present value of P's tax savings would be similarly limited. Were P to pay $8,500,000 to acquire L, P would be entitled to utilize but $10,200,000 of L's net operating

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2 For purposes of this illustration, the surtax exemption on the first $100,000 of L corporation's annual taxable income has been disregarded. Other discount rates produce differing present values of the estimated tax savings.

loss carryovers over five years.[3] Were P to pay $10,000,000 to acquire L, P would be entitled to utilize $12,000,000 of L's net operating loss carryover -- an increase of $1,800,000. That increase would eventually provide $828,000 of tax benefits to P at an immediate cost of $1,500,000 in additional purchase price. The transaction is not economic and would not be effected by knowledgeable participants. In this manner, the Recommendation limits the artificial augmentation of purchase price to increase tax attribute utilization.

Where L has a net operating loss carryover of $15,000,000 and no other assets, under the Recommendation no knowledgeable purchaser would buy L to gain its tax attributes. Were P to buy L for $100, P would be entitled to claim $120 of tax deductions (over 60 months) yielding a projected tax saving of only $55.20. Thus viewed, the transaction simply makes no sense; under the Recommendation, there will be no purchases of shell companies to acquire their tax attributes.

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3 The Recommendation would gross up the $8,500,000 purchase price by 20 percent in fixing the section 382 attribute limitation and spread its utilization over 60 months. The result permits P to use fewer carryovers than would be available to L, but to use them over a shorter period, yielding approximately the same present value. In effect, the purchaser, P, assumes the risk that it will not be able to fully utilize the section 382 attributes ratably over 60 months, while the Government is procected by the 60-month phase-in from having those attributes used more quickly. Some commentators argue the neutrality principle would be best served by permitting an immediate utilization of losses equal to 100 percent of the purchase price. Others suggest the purchaser be provided an election to spread the loss utilization over a longer period -- up to 15 years -- with a concomitant increase in the gross up to maintain the present value equilibrium. The first suggestion has been rejected as unduly favoring larger prospective purchasers over smaller ones. The second has been rejected as introducing too much complexity for so little improvement.

The purchase-price-reference limitation for section 382 attributes approximates the results that would flow from more sophisticated (and much more intricate) computations. Were the purchase price separated into its two components -- the target's income producing assets and its section 382 attributes -- and discount rates applied to the anticipated tax savings to be realized from utilizing the section 382 attributes, the resulting values would approximate or be somewhat more than or somewhat less than the purchase price, depending on the discount rates used. Formulae that achieve a more precise result than the purchase price approximation require more complexity and mathematical exactitude than policy considerations require. The purchase price limitations are not unreasonable approximations and are a vast improvement over existing law. By permitting the section 382 attributes to be grossed up to 120 percent of the purchase price over 60 months, the Recommendation would help place small prospective purchasers on an equal footing with large prospective purchasers.

The proposed statute uses the term "acquisition value" as the reference point for effecting the neutrality principle. The acquisition value is defined as the fair market value of all outstanding stock of the target corporation immediately before the change in control. Some commentators suggest that acquisition value also include the cost of all target corporation debt purchased by persons who acquire control of the target corporation -- regardless from whom the debt is purchased. The justification for including purchased corporate debt in acquisition value would be to permit sellers and purchasers greater flexibility. If, for example, former owners of the target corporation converted old and cold corporate debt to stock prior to the change in control, under the Recommendation, the acquisition value would include the value of all outstanding stock of the target corporation including the value of the stock issued for the old and cold debt. They argue that a direct purchase of the debt should yield the same result. But debt is different from stock. Where the target corporation has outstanding debt -- even if it all be in the hands of a purchasing shareholder -- the target corporation's future income will be reduced by the interest paid (or accrued) to the debtholder, while the debtholder would realize a concomitant amount of interest income. On balance, to augment the acquisition value by unconverted debt is an unwarranted complexity. The Recommendation would, however, increase acquisition value by the cost of debt (or its fair market value, if less) converted to equity, whether by old debtholders or new purchasers of the target corporation's debt.

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If T is insolvent and P purchases T's debt from a third party creditor at a discount, under section 108(e)(4), T may be treated as having non-taxable discharge of indebtedness income, resulting in a reduction in T's NOLs and credit carryovers under section 108(b)(2)(A). If P purchases and converts an insolvent T's debt to T equity, the purchase and conversion should be treated as an issuance of T's stock for debt — a transaction not giving rise to cancellation of indebtedness income and not subject to the rules of section 108(a)(1) or (b). At the very least, ordering rules should provide that any reduction in T's NOLs or credit carryovers effected under section 108, would be effected before applying the acquisition value limitations of section 382.

The Recommendation would limit the utilization of section 382 attributes following a change in corporate ownership. These attributes are:

1. 100 percent of net operating loss carryovers (and net built-in ordinary losses) (section 172);

2. 60 percent of net capital loss carryovers (and net built-in capital losses) (section 1212); and

3. 200 percent of all credit carryovers (sections 38, 39 and 904(c)).

The Recommendation would take into account both built-in losses and built-in gains, i.e., unrealized losses and gains that have accrued before the change in control but have not been recognized. As a modest simplification, built-in losses and gains not recognized within five taxable years following the change in control are disregarded.

From and after a change in control, section 382 attributes would be limited to the sum of built-in ordinary gains plus 60 percent of built-in capital gains, and a specified percentage of the corporation's pre-change value (i.e., its purchase price). The specified percentage would rise by two percent each month, commencing with the month in which the change in control is effected, to a permanent peak of 120 percent in the sixtieth month and all subsequent months.

A "change in control" is defined as a transaction (or integrated series of transactions) resulting in a decline of at least 50 percentage points in historic shareholders' ownership percentages of participating stock, generally, stock that

participates in growth not substantially below its participation in present net worth. To prevent abuse, the Commissioner is authorized to issue regulations treating options and convertible or participating debt as participating stock in determining whether a change in control has been effected. Generally, the transfer of participating stock pursuant to the exercise of an option will be taken into account in determining whether a change in control has been effected. If, under applicable regulations, the issue or purchase of that option triggered a change in control, the exercise of the option should be disregarded.

In determining whether a change in control has been effected, certain transactions are excluded: transfers of shares between related persons or divorced spouses; gifts and inheritances; increases in holdings of certain creditors; and small transactions (those not involving either five percent or more of the outstanding participating stock or a holder of at least five percent of the corporation's participating stock).

Both built-in losses and gains are included in the proposal because they could have been recognized by the seller before the change in control without affecting the value of the loss corporation or its future real income-producing potential at the time of the change. In the case of a built-in loss, had it been recognized before the change, it would have been subject to the post-change limitations on recognized losses, so the proposal makes it subject to the same limitations. In the case of a built-in gain, had it been recognized before the change, it would have avoided tax by offset against losses and loss carryovers without limitation. Accordingly, the proposal permits pre-change losses to offset built-in gains when they are recognized. Because built-in gains increase the limitation only when actually recognized, their mere existence, without recognition, does not increase the limitation. The presence of built-in gains permits their eventual offset against pre-change losses, but does not permit the offset of additional amounts of other income against pre-change losses.

Some critics, despite their general acceptance of the neutrality principle, argue that public confidence in the integrity of the tax system would be undermined if a corporation with nothing but cash, cash equivalents and favorable tax attributes were able to be sold with its attributes more or less intact. They argue that any loss corporation that owns any investment assets must have its "purchase price" (that fixes its potential tax attribute utilization) reduced by the value of its investment assets in fixing the amount of tax attribute carryover.

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The Recommendation rejects this suggestion for two reasons. First, it is inherently inconsistent with the neutrality principle and would impede economically justified transactions. For example, consider a loss corporation with Treasury bills worth $1,000 and accumulated losses of $1,000. If the Treasury bills pay 10 percent per year, the corporation would earn $100 per year for ten years and pay no tax. In a world where corporations generally pay tax, this corporation is plainly worth more than $1,000 to its owner, because it produces an after-tax return, at least for ten years, of 10 percent, rather than 5.4 percent. If the loss carryovers are denied, a purchaser would pay no more than $1,000 for the corporation. Consequently, the tax law will have effectively prevented its sale at a price equal to its value in the hands of its present owner.

The second reason is simplicity. Were an investment assets adjustment rule included, it would require distinguishing business assets from investment assets whenever a change of control is effected. In which category is rental real estate? Does the categorization turn on whether the real estate is net leased? How would "investment assets" be distinguished from working capital utilized in a business? The degree of complexity inherent in distinguishing investment assets from business assets can be justified only by compelling policy reasons not believed to be present here.

One anti-abuse rule has been included as essential to protect the integrity of the neutrality principle. The rules should not permit an inflation of the corporation's value by infusing additional assets -- and hence an inflation of the purchase price and tax attribute utilization -- shortly before the sale. To achieve this purpose, the Recommendation would reduce the deemed purchase price by an amount equal to the value of assets transferred to the target corporation as contributions to its capital or in exchange for its stock during the two pre-change taxable years immediately preceding the change in control (or otherwise in anticipation of the change), except to the extent of the target corporation's losses during these two years and to the extent the infusions arose in the ordinary course of the target's business and not in anticipation of a change in control. The seller's infusion of assets to finance current losses should not be perceived as an abusive inflation of the corporation's value. If the target corporation reduces its outstanding indebtedness as a result of a contribution to its capital or by issuing stock in exchange for debt, in testing whether the deemed purchase price should be reduced, the date

the assets were transferred to the target corporation in exchange for the debt -- not the date of the conversion -- will be the relevant testing date. Thus, where a debtor (whether a pre-existing shareholder or not) exchanges debt for stock, the two year rule and the ordinary course of business exceptions will apply to the date the indebtedness was incurred.

If the limitations on section 382 attributes operate to defer utilizing all or a portion of a net operating loss carryover, section 172 will not reduce any carryover by an amount greater than that actually utilized.

If the proposals advanced in this Recommendation are enacted, the Treasury Department will have to consider its effect on the SRLY (separate return limitation years) provisions of the consolidated return regulations. Presumably, the SRLY restrictions will be abolished or at least severely curtailed.

Finally, because the Recommendation would include within section 382 comprehensive rules for the limitation of loss and credit carryovers and built-in losses, it would exclude those attributes from the scope of section 269. Where post-acquisition losses are not built-in losses, but instead are operating losses or losses from the sale of assets attributable to a a post-acquisition decline in value, neither section 269 not section 382 will limit their utilization. The Recommendation would overrule contrary holdings. See R.P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962), and Zanesville Investment Co. v. Commissioner, 38 T.C. 406, rev'd, 355 F.2d 507 (6th Cir. 1964).

The Recommendation blocks transfers of net operating losses from one taxpayer to another pursuant to "net operating loss loanout" arrangements exemplified by the famous Maxwell Hardware Co. v. Commissioner decision, 343 F.2d 713 (9th Cir. 1965).

In Maxwell Hardware, the loss company's net operating loss carryovers sheltered the income earned from an unrelated real estate business newly transferred to the loss corporation by two new investors. The specially crafted preferred stock held by the new investors was entitled to receive 90 percent of the profits from the real estate business, leaving the remaining 10 percent for the common stock owners. Under proposed section 382(f)(3), because the common stock in Maxwell Hardware that possessed 60 percent of the corporation's present net worth was entitled to only 10 percent of the corporation's growth, the common stock would not be participating stock. Accordingly, the

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Maxwell Hardware arrangement would, under the Recommendation, involve a change in control as defined in section 382(c), subjecting the corporation to the limitations on its section 382 attributes.

Some partnerships have been organized by loss companies and active business companies under agreements whereby the loss company is allocated all (or substantially all) of the partnership's profits either for a number of years or to a targeted dollar amount. Thereafter, all (or substantially all) of the profits are allocated to the business partner. This net operating loss loanout arrangement utilizes the loss company's net operating loss carryovers to shelter the income that otherwise would be taxed to the business partner.

The Recommendation's specific statutory language does not address that situation, even where the loss company is a corporation. (Similar arrangements have been effected using individuals with net operating losses or tax exempt entities in place of loss corporations.) While the results sought by the taxpayers in these circumstances may not be deemed abusive, the results have been criticized. Perhaps section 482 or assignment of income principles could be invoked to deny the utilization of net operating loss shelter. In addition, under section 704(b), the allocation of the partnership's income to the loss company partner can be reallocated if the partnership agreement allocation does not have substantial economic effect.

The proposed amendments have been drawn to achieve simplicity. That objective, while not fully achievable, permits us to hope that, given the clear rationale of the neutrality principle, the courts can resolve interpretative questions in a predictable way, keeping in mind that the goal is to place the purchaser in the position the seller could have been expected to have occupied.

No Section of Taxation recommendation addresses the same issues as the present Recommendation.

No member of the originating committee or of the Council of the Section of Taxation is known to have a material interest in the Recommendation by virtue of a specific employment or engagement to obtain the result of the Recommendation. It is recommended that the amendment be given only prospective application, except for the repeal of the 1976 rules governing similar transactions, which are not scheduled to take effect until 1986. In that case, clients would not be affected in any pending matter.

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Suggested Statutory Language

The following statutory language is suggested for purposes of the Recommendation:

Sec. 1. Section 382 is amended to read as follows:

SEC. 382: LIMITATION OF CERTAIN CORPORATE TAX ATTRIBUTES FOLLOWING A CHANGE IN CONTROL

(a) DEFINITIONS. -- For purposes of this section:

(1) A "target corporation" is any corporation that undergoes a "change in control" described in subsection (c);

(2) A "pre-change taxable year" of a target corporation is a taxable year that begins before the date on which the change in control occurs;

(3) A "post-change taxable year" of a target corporation is a taxable year that begins on or after the date on which the change in control occurs;

(4) A "pre-change carryover" of a target corporation is a carryover from a pre-change taxable year to a post-change taxable year of the target corporation; and

(5) If the change in control occurs during a pre-change taxable year, the target corporation's income or loss for that taxable year shall be treated as pre-change taxable year income or loss or post-change taxable year income or loss in amounts that bear the same ratio as the number of days in the taxable year before and after the date on which the change in control occurs bear to the total number of days in the taxable year.

(6) The "section 382 attributes" of a target corporation are:

(A) 100 percent of its pre-change net operating loss carryovers and built-in ordinary losses described in subsection (e);

(B) 60 percent of its pre-change capital loss carryovers and built-in capital losses described in subsection (e); and

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(C) 200 percent of its pre-change tax credit carryovers.

(b) LIMITATION DEFINED. -- For any pre-change taxable year of a target corporation during which a change in control occurs and for each post-change taxable year, the aggregate amount of section 382 attributes allowable for that taxable year and all previous such taxable years, shall not exceed the sum of:

(1) any pre-change taxable income described in paragraph (a)(5); plus

(2) 100 percent of built-in ordinary gains, and 60 percent of built-in capital gains, recognized during those taxable years; plus

(3) the product derived by multiplying the acquisition value as defined in subsection (d) by a percentage equal to 2 percent times the number of months (not to exceed 60 months) that have ended on or after the date on which the change in control is effected.

(c) CHANGE IN CONTROL DEFINED.

(1) IN GENERAL -- For purposes of this section, the term "change in control" means any transaction (or integrated series of transactions) that produces a shareholder continuity ratio of less than 50 percent. The shareholder continuity ratio is the sum of fractions derived for all holders of participating stock in the target corporation immediately before the transaction, each fraction being the lesser of the shareholder's relative participating stock interest in the target corporation immediately before and immediately after the transaction. Under regulations prescribed by the Secretary, changes in beneficial ownership of a holder and in the holdings of options or convertible or participating debt may be deemed a change in the ownership of participating stock of the target corporation and changes in legal ownership may be ignored to the extent no changes have been effected in the beneficial ownership of those participating shares. Where the change in control results from an integrated series of transactions, the change in control occurs when the shareholder continuity ratio first falls below 50 percent.

(2) EXCEPTIONS. -- In applying paragraph (1), the following transactions shall be disregarded:

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(A) Transfers of shares between persons who, at the time of the transfer, are each actual or constructive owners of the transferred shares under the rules prescribed by section 318(a) (other than paragraph (4) thereof), applied without regard to the 50-percent limitations contained in paragraphs (2)(C) and (3)(C), provided, however, in determining the number of shares considered to be owned by the transferee, there shall be taken into account stock of the target corporation owned directly or indirectly by the transferee and for purposes of applying paragraph (3)(C), that proportion which the value of the stock owned, directly or indirectly, by the transferee bears to the value of all the stock in the corporation from which the shares are attributed;

(B) Transfers of stock to the extent that the transferee's basis is determined under section 1014 (relating to property acquired from a decedent) or section 1015(a) or (b) (relating to property acquired by gift or transfer in trust), and transfers of stock in satisfaction of a right to receive a pecuniary bequest and transfers described in section 1041 (relating to property transferred to a spouse or former spouse);

(C) Acquisitions of stock by a creditor of a corporation in exchange for a creditor claim against the corporation, but only if the claim was not created or acquired principally for the purpose of obtaining the stock, and only if the stock is received (i) in a title 11 or similar case (within the meaning of section 368(a)(3)(A)); (ii) where (but only to the extent) the debtor corporation is insolvent; or (iii) where at least 50 percent of the total indebtedness of the corporation is extinguished pursuant to the exchange plan; and

(D) Any other transaction that does not involve, and which is not part of an integrated series of transactions involving, either (i) more than five percent of the value of all outstanding participating stock of a corporation or (ii) a holder of more than five percent in value of its participating stock.

(d) ACQUISITION VALUE DEFINED. -- For purposes of this section, the term "acquisition value" means the fair market value of all outstanding stock of the target corporation immediately before the change in control. Where assets have been transferred to the target corporation in exchange for debt more than two years preceding the change in control, and in connection with the change in control, that debt is converted into stock of the target corporation, the acquisition value shall be increased by the lesser of the fair market value or the tax basis of debt so converted. The acquisition value shall be reduced by the excess of (1) so much of the acquisition value attributable to (i) assets (net of attendant liabilities) contributed to the target corporation as contributions to capital or from the target's sales of its stock during the two pre-change taxable years preceding the change in control, and (ii) other assets (net of attendant liabilities) added to the target corporation as part of or in anticipation of the change in control, over (2) the target corporation's ordinary course of business losses (ordinary and capital) recognized during the two pre-change taxable years preceding the change in control. There shall be excluded from amounts described in clause (1) of the preceding sentence (i) assets added to the target corporation pursuant to its ordinary course of business needs and not as part of or in anticipation of the change in control, as established by the target corporation (or its successor) to the satisfaction of the Secretary and (ii) the lesser of the fair market value or the tax basis of debt converted into stock, but only if the converted debt was issued in exchange for assets transferred to the target corporation more than two years preceding the change in control.

(e) BUILT-IN LOSSES AND GAINS. -- For purposes of this section, "built-in" losses and gains are those unrealized target corporation losses and gains that have accrued prior to the change in control but are not recognized until after the change in control; provided, however, that losses or gains recognized more than 60 months following a change in control shall in no event be treated as built-in losses or built-in gains.

(f) OPERATING RULES. --

(1) ABSORPTION OF CARRYOVERS. -- In each post-change taxable year, built-in ordinary losses shall be absorbed first, followed by built-in capital losses. Thereafter, net operating loss, capital loss, and credit carryovers from pre-change taxable years shall be absorbed in any sequence elected by the taxpayer. In the absence of filing

an election, attributes shall be allowed and absorbed in the following order of priority: built-in ordinary losses, built-in capital losses, capital loss carryforwards, operating loss carryforwards and credit carryforwards.

(2) PRESERVATION OF UNABSORBED ATTRIBUTES. -- If section 382 attributes are not allowed solely by virtue of the limitations of subsection (b), the amounts not allowed shall be included in section 382 attributes carried over to subsequent years notwithstanding the provisions of section 172(b)(2).

(3) DEFINITION OF PARTICIPATING STOCK. -- For purposes of this section, the term "participating stock" means all stock with a proportionate participation in growth that is not substantially below its proportionate participation in present net worth, determined at the time of the potential change in control, and a shareholder's "relative participating stock interest" for purposes of subsection (c)(1) and his interest in participating stock for purposes of paragraph (D) of subsection (c)(2) shall be determined by reference to the value of his participating stock as measured against the value of all participating stock.

Sec. 2. Section 383 is repealed.

Sec. 3. Section 269 is amended by adding, at the end thereof, a new subsection (d), to read as follows:

(d) Subsections (a) and (b) shall not be applied to reduce, eliminate, or otherwise adjust or alter any section 382 attribute referred to in section 382(a).

Sec. 4. Section 806(e) of the Tax Reform Act of 1976 is repealed.

Sec. 5. (a) Sections 1, 2, and 3 hereof shall apply to taxable years beginning after the date of enactment of this Act.

(b) Section 4 hereof shall be effective as of the date of enactment of the Tax Reform Act of 1976.

Sec. 6. For purposes of applying section 382, as amended by section 1 hereof:

(a) Changes in control of a target corporation occurring before the beginning of the first taxable year to which section 382 as so amended applies shall be disregarded; and

(b) The section 382 attributes of a target corporation shall not include any attributes to the extent they have been eliminated or reduced by virtue of section 269, 382, or 383 as in effect prior to taxable years beginning after the date of enactment of this Act.

Comments on Suggested Statutory Language

Conforming and clerical amendments have not been made.

Chairman RANGEL. I thank you, and I also thank the American Bar Association for consistently taking the time out to give us help and assistance, especially with the draftsmanship, which is so necessary to get started on some of these complex questions. We appreciate the contribution that you have made this morning.

Mr. LEWIS. Thank you, Mr. Chairman.

[The following was subsequently received:]

AMERICAN BAR ASSOCIATION,
Washington, DC, June 12, 1985.

Re carryover of net operating losses and other corporate tax attributes of corporations.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: I write to supplement my May 22 testimony on the above subject. I present supplemental views below on two subjects: (1) The treatment of investment assets and (2) insolvent corporations, particularly those involved in Title 11 proceedings (and, even more particularly, troubled financial institutions).

A. *Investment Assets.*—The Association carefully considered the "investment assets" question in developing its legislative recommendation for a new rule for corporate attribute carryovers following a change in a corporation's control. For a combination of theoretical and practical reasons, special treatment of investment assets was rejected.

From a theoretical standpoint, an investment assets limitation is inconsistent with the "neutrality principle" that is the cornerstone of our recommendation. We seek to limit corporate tax attribute utilization following a change in control to an amount roughly equivalent to the value of those attributes in the hands of the target corporation had there been no change in control. That goal would not be achieved if tax attribute utilization were computed without regard to investment assets or denied to corporations that possess more than a prescribed percentage of such assets. To do so would frequently render the value of the attributes to the purchaser significantly less than their value to the seller—a rule that would impede economically desirable purchases and sales of corporate businesses. An ideal tax rule would afford a purchaser attribute utilitzation of the same value as would have been afforded the seller had no change in control taken place.

Consider a corporation that has a net operating loss carryover of $10,000 and owns $20,000 of Treasury bonds, yielding 10% per year. To its present owners, that corporation is worth somewhat more than $20,000, because, by virtue of its loss carryovers, the corporation will not have to pay income tax on the $2,000 of interest it earns each year for the next five years. Were the tax law to deny a purchaser who pays $23,000 or more for the stock of the corporation the economic benefits of using those attributes, that law would effectively prevent the sale of the corporation. No knowledgeable purchaser would pay more than $20,000 for the corporation and no knowledgeable seller would accept only $20,000.

A slight change in facts will better illustrate the problem inherent in an investment assets limitation. Suppose that the corporation also operates a small business worth $5,000 that produces a profit of $1,000 per year, susceptible to improved profit performance with the infusion of better management. Sound economic and tax policy should encourage the transfer of the corporation to a purchaser at a price of $28,000 who could more effectively manage it and increase its productivity. If the corporation's $20,000 of investment assets were required to be subtracted from the $28,000 purchase price before computing the percentage limitation on loss carryover utilization, the tax law would discourage any transer of the business because only $8,000 (or less) of the purchase price would be used in the tax attribute utilization formula. In the hands of the seller, the corporation could earn $3,000 a year without paying tax. In the hands of the buyer, depending upon which formulation is used, (i) no carryover utilization would be permitted; or (ii) only a stipulated percentage of the $8,000 purchase price not attributable to the investment assets would be permitted. In either event, the disparity between sellers and buyers in their ability to utilize tax attribute carryovers would make it difficult, or even impossible, for the parties to agree on a fair purchase price.

Some critics improperly attempted to compare the investment assets situation with safe harbor leasing. Safe harbor leasing permitted taxpayers who could not use tax attributes to transfer them to other taxpayers who could use them. Safe harbor

leasing thus differs markedly from the ABA proposal designed to permit purchasers to use attributes only to the extent those attributes could have been used by sellers.

From the practical standpoint, a limitation based on investment assets would introduce unwarranted complexity and uncertainty into the bargaining and tax administration processes. No acceptable definition of investment assets is readily available. Consider, for example, whether the following assets are investment assets:

Working capital held in the form of cash or temporary investments (*e.g.*, Treasury bills);

Real property held for rental under a net lease;

Stocks, options, commodities, or futures contracts held in an actively managed portfolio, including hedging transactions;

Property of any kind subject to an executory contract of sale or a put or call option;

Stock in subsidiaries (80% owned, 50% owned, or 20% owned).

The above examples illustrate that an investment assets limitation would be difficult to draw, complex and a breeder of controversy. Fortunately, there is no real need for such a limitation.

B. Insolvency.—Under the neutrality principle, an insolvent corporation, with no significant net worth or earnings potential, would be permitted no significant attribute utilization following a change in control

Where an insolvent corporation's creditor interests are exchanged for stock, our recommendation would not treat that exchange as a change in control. Consequently, the corporation's tax attributes would remain fully available to its former creditors, now its shareholders. To avoid the attendant delays and costs of formal proceedings in the federal courts, our recommendation would apply this rule to informal, as well as formal, creditor arrangements.

Where "old and cold" debt is converted into equity—whether by the old owners of that debt or the purchasers of that debt—our recommendation would not treat that conversion as a "stuffing" of the corporation. Thus, the "purchase price" guide for determining the allowable tax carryover utilization would include the purchase price of that debt, i.e., the lower of its original cost or its fair market value on the date of its conversion.

We recognize that Congress may want, in rewriting Section 382, to provide separate rules for troubled corporations, particularly financial institutions. Special incentives for rescuing troubled financial institutions may be justified because of the special role they play in our economy and the wide deleterious effects that their insolvency may produce. If Congress should determine to provide special rules for troubled financial institutions that differ from those provided for other insolvent corporations, we would urge that the legislative history specifically note that deviation, its justifications, and its limits. Subject to that special exception, the neutrality principle we propose would remain operative.

I hope this letter, coupled with my testimony, will be helpful to you and your staff as you proceed to consider this area, widely recognized as one riddled with a confusing and conflicting history of policy objectives and implementations. We believe the time—and mechanism—has come to rationalize the area and look forward to working with you as your considerations proceed.

Respectfully submitted,

JAMES B. LEWIS.

Chairman RANGEL. The New York State Bar Association Tax Section is next.

I assume you could go directly to Treasury with your recommendations, but I am glad you did not bypass the committee.

Mr. LEWIS. If I may interrupt, Mr. Chairman, I should have recognized Mr. Jacobs when I spoke, because he is the chairman of the American Bar Association Tax Section's Committee on Corporate Shareholder Relationships, and I think of him as the real author of the statutory language I was recommending to you.

Chairman RANGEL. Well, I congratulate him for the work that he has done, and thank him for it.

STATEMENT OF ROBERT A. JACOBS AND RICHARD O. LOENGARD, JR., COCHAIRMEN, COMMITTEE ON REORGANIZATIONS, TAX SECTION, NEW YORK STATE BAR ASSOCIATION

Mr. JACOBS. Thank you, Mr. Chairman.

Richard Loengard and I are pleased to be here to represent the New York State Bar Association. I guess the thing I would like to do is impress upon you how pleased we are to be here among friends.

It has been 9 years at least since 1976, and it has been a lot longer since 1958, and this problem has been here festering for a very, very long time, and suddenly, although not without a lot of labor, and a lot of good will by a lot of people, what you have emerging is a real consensus of thought.

The proposals that are before you today, in one form or another, regardless of which of the pieces of testimony that you take, and when you get a chance to read the Senate Finance Committee staff report, which not surprisingly is not all that dissimilar from the ABA proposal, not that dissimilar from what Messrs. Bacon and Tomasulo talked about, because all of us have been working together to try to address and develop and answer these problems, and while there is testimony, prepared testimony, of Mr. Lewis, and of our bar association, going to various details, where there are differences in how one should treat a look back, and what constitutes an acquisition, should you use a 3-year rule, or should you use a transaction, or series of transactions to judge when a change of control has taken place, it is important not to lose sight of the fact that the ALI, the ABA, the New York State Bar, the City Bar of the City of New Yor', and the Senate Finance Committee staff working through its auxiliary group of professors, practitioners and Government officials, have really arrived at the same place.

And what that place is is what we call the neutrality principle. It means that the losses that are available to the loss corporation should be made economically available to the profit corporation, the acquiring corporation, and what you try to do is take the profit out of this acquisition of loss companies.

Under the existing rule——

Chairman RANGEL. I am going to have to interrupt, because the second bell means that we have a vote on the floor, so the committee is going to have to recess for 5 minutes. I beg your indulgence, and I will return.

[Short recess.]

Chairman RANGEL. The committee will continue the hearings. There were two votes, and I apologize for the delay. You were saying?

Mr. JACOBS. Under existing rules, a buyer of a business may find itself either being grossly enhanced or unfairly treated as compared to the ability of the seller to utilize those tax attributes. It doesn't make sense. The present rules under section 382 are all-or-nothing, in large measure, type rules, and the same—worse—in the 1976 version of section 382.

What you have being developed in the Treasury testimony, the Senate Finance Committee staff report, the ABA draft legislation is an application of the neutrality principle by the American Law

Institute based on the purchase-price formulation by the Ways and Means Advisory Group in 1959. It really makes sense, it's basically simple. What must be done, in addition to simplicity, is to make it certain.

And where you have simplicity and where you have certainty working in combination, then the buyers and sellers can meet in the market place and fix a price that is fair for those tax attributes which we as a country determine, as a matter of tax policy, may be transferred from one to the other.

Under existing law what you have in practice is that buyers generally get a much better result than do the sellers; that is to say, the buyers make bargain purchases of tax attributes, the sellers don't get fair value, and the Treasury takes it in the neck because it ends up getting 46 cents on every dollar of that loss, even though no dollar—nor the cents—was ever paid in the form of purchase price or otherwise.

This is a situation that should not be continued. This is a situation that can be changed. And, after all these years and all this thought, I think we have a situation that is now ready for appropriate congressional action.

The New York State Bar would be delighted to work with your staff and help develop the best possible legislative result. We think the time has come, we think that the ABA draft is the draft off of which you should work.

[The prepared statement follows:]

STATEMENT OF THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

We are Robert A. Jacobs and Richard O. Loengard, Jr., co-chairs of the Committee on Reorganizations of the New York State Bar Association Tax Section. We appear on behalf of the NYSBA Tax Section.

The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. The Tax Section is pleased to share with you its views on the proper means of dealing with the carryover of tax attributes in various corporate settings.

Several members of the Tax Section have participated over the past two and one-half years with staff members of various Congressional committees, Treasury Department and Internal Revenue Service officials and representatives from other professional organizations together with respected academics in examining, among other subjects, changes in the treatment of carryovers of tax attributes. In the course of those endeavors a consensus has emerged on a large number of the issues. Part of that emerging consensus is the proper treatment of tax attribute carryovers. We join with the other participants in this effort in urging the prompt enactment of a new Internal Revenue Code section 382 that would provide exclusive limitations for tax attribute carryovers following a change in control of the target corporation possessing those tax attributes. We further join in urging that utilization of those corporate tax attributes be limited to a percentage of the target corporation's value before the change in control—a value generally measured by the purchase price of the target loss corporation.

The Tax Section believes that sections 382 and 383, as currently in effect (*i.e.*, without giving effect to the 1976 amendments), are neither an effective nor a fair method of permitting appropriate utilization of carryovers in some transactions or of preventing perceived inappropriate trafficking in loss carryovers and other corporate tax attributes. To the extent the application of those sections in a purchase transaction turns on the continued conduct of a business, they may require continuation of uneconomic activities merely to preserve tax attributes. For example, under Treasury Regulations, a change in the location of the business may cause the loss of all tax attributes. Conversely, if the business is continued, *all* corporate tax attributes may be preserved regardless of the relative value of the business and those attributes. The Tax Section believes, further, that the other principal statutory provision that may be applicable in these transactions, section 269, is often random in

operation, unfairly penalizing some transactions and leaving unaffected other transactions that should be subject to tax attribute reductions. As such, it improperly introduces a speculative factor in the pricing of business acquisitions, resulting in windfalls or losses depending upon unpredictable audit and litigation results.

"New section 382," *i.e.*, the 1976 version, is ill suited to the problem. While it would double the length of present Code section 382 and provide a minefield of interpretative problems, complexity and uncertainty,[1] it would also deny all net operating loss carryforwards or other attributes where all the stock of the target has been purchased. Denial would occur—merely by reason of a change in control—even as to attributes that the target could reasonably be expected to have utilized had it not been purchased.

While a substantive minority of the Tax Section Executive Committee believes changes in section 382 should be delayed until the tax reform proposals presently being discussed have been considered and acted upon, the majority of the Committee believes the proper resolution of the tax attribute carryover problem is now to embrace the "neutrality" principle enunciated by the American Law Institute ("ALI") in its 1982 report. That principle is embodied in the American Bar Association Tax Section's Legislative Recommendation 1985–1 (the "ABA Draft"), and while we do not suggest that the precise formulation of the ABA Draft (allowing 5 years of carryforwards at a rate of 24% of the purchase price) is the only correct result, we do believe that a purchase price limitation equating on a discounted present value basis to a high percentage of the purchase price is appropriate.

The key to applying the neutrality principle is approximating and preserving the value of the tax attributes as they exist in the hands of the seller—without enhancement or diminution—in the hands of the buyer. In other words, the favorable tax attributes available to the buyer should equal those attributes available to the seller. In practice, that equality may be difficult to achieve, but it should be sought and effected wherever possible. The ABA Draft seeks that result and approximates it in most cases. In some cases, the ALI or Senate Finance Committee Staff would achieve these results—with greater or lesser equity—by applying somewhat different formulae. Under a neutrality-principled statute, tax attributes may be transferred, provided the transfer is incident to an acquisition of income-producing assets, *i.e.*, part of a corporate acquisition. Adopting the neutrality principle would not permit the mere trafficking in loss carryovers, but in appropriate cases would enable a loss corporation to transfer freely its beneficial tax attributes as part of an overall change in its control. Properly structured and applied, a statute based on the neutrality principle would provide sellers with fair compensation for the tax attributes transferred by them to buyers, prevent buyers from obtaining tax attribute windfalls and leave the Treasury Department neither enhanced nor diminished by tax attribute transfers.

The ABA Draft implements these principles, utilizing a single purchase price rule to establish the amount and rate at which tax attributes may be utilized following a change in control of the target corporation.[2] As mentioned, the ABA Draft uses a five-year period and a rate of 24% of the purchase price. You should note that the 24% assumes a 10% discount rate and a 20% pre-tax rate earnings rate, as well as a five year earn-out, and that if those assumptions are changed, the result changes. We believe that the ABA Draft's rate assumptions comport with business reality and are within the range of a correct result. We support the ABA Draft's approach to achieving tax neutrality.

On September 22, 1983, our Tax Section testified before this Subcommittee suggesting "that the Committee carefully consider the possibility of a single limitation measured by the purchase price for the loss corporation itself." We noted that under that approach, it would be impossible for an acquiring corporation to profit from the purchase of tax losses, because the tax benefit from the tax loss is always a lesser amount than the loss itself. We observed that adopting a single purchase rule for all transactions would avoid complexity. On October 24, 1983 in a hearing before the

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[1] See New York State Bar Association, Tax Section, "Report on Section 382 of the Internal Revenue Code as amended by the Tax Reform Act of 1976," 31 Tax Lawyer 283, 284 (1978).

[2] The ALI version of the "neutrality" contained a different method for ascertaining the available NOLs after reorganizations. In a simple case, a corporation, with only common stock outstanding, acquires, solely for common stock, another corporation. If either corporation has an NOL, the combined company can use a percentage of the NOL, the percentage depending on the percent of stock of the combined companies held by the loss company's former shareholders. While this proposal avoids the need to value the stock in question, it does not apply to purchase acquisitions, nor is it easily applied when complex corporate structures, or transactions, are involved. We favor a single rule that can be generally applied to all types of transactions—all stock, all cash and part stock, part cash.

Committee on Finance, United States Senate, then Tax Section chairman, Willard B. Taylor, testified that a single purchase rule for section 382 could either limit carryovers to an interest-like return on the purchase price or to a lump sum amount. The ABA Draft provides a simple gross up of the purchase price to 120% of the purchase price and then spreads its utilization over 60 months following a change in corporate control. We believe this a rational application of the neutrality principle, properly balancing the theoretical application of the principle with business realities. The 60-month utilization balances the need not to unduly favor large potential acquirors over smaller ones with a realistic view of the time span businesses look to recover their investments in purchased tax attributes.

Under the neutrality principle, it would make no difference whether the target loss corporation had all active business assets or all passive investment assets. The only question is the ability of the target corporation to earn income from its assets against which the favorable tax attribute may be applied. We recognize that you may seek to limit the carryover of tax attributes to cases where a stipulated portion of the target's assets are business assets. If you do so decide, we believe the relevant measuring date should be the date on which a binding contract is entered into and that no requirement be expressed or implied as to the length of time the business assets must have been held by the target or retained by the purchaser.

Many corporations—especially small corporations—are capitalized with both debt and equity. Where the debt is "old and cold" we believe it should be treated as part of the purchase price, if the debt is coverted into equity either before the change in control or promptly thereafter. This again is merely an application of the neutrality principle, placing the buyer in the same position as the seller.

One of the principal goals of any remedial legislation in this complex area should be certainty. Here we join the Senate Finance Committee Staff and the ABA in urging that the section 382 rules operate exclusively in this area. Section 269 should not apply whenever a transaction is governed by section 382.

In drafting any amendments to section 382, care must be taken to assure appropriate treatment for insolvent target corporations that undergo reorganizations either under the bankruptcy laws (title 11) or pursuant to informal arrangements. Special care must also be given to acquisitions of troubled thrift institutions.

We recognize that reasonable people can differ as to the best means of effecting the neutrality principle. Were we to attempt to draft a statute embodying that principle, we might make some decisions different from those made in the ABA Draft. No doubt you and your staff could devise statutory language embodying that principle that would differ materially from the ABA Draft version. But we do not believe any noble cause would be served by starting anew. The ABA Draft is a thoughtful and comprehensive approach to the tax attribute carryover problem. We join the ABA in urging you to use its draft to formulate your legislation, thus measurably reducing the risk of unforseen problems and unintended results. We shall be pleased to work with you and your staff in developing this legislation. We are pleased to join with you in this effort to end—at last—the long period of uncertainty as to how tax attributes should be treated in corporate acquisition transactions. Finally, we note that this testimony addresses tax attribute carryovers in our present corporate tax environment. If major tax reform proposals are enacted, a somewhat different provision may be more appropriate.

Chairman RANGEL. We thank you for your past contributions.

You establish a rate of 24 percent, is that right?

Mr. JACOBS. The ABA draft uses a rate of return of 24 percent, but the way it works is as follows. It's not 24 percent a year; it's 100 percent of the purchase price, and on the assumption that a buyer of a business would be willing to purchase a business only if he felt he could get a 20-percent return. And we think that is consonant with business reality.

Chairman RANGEL. Did you study the Senate Finance Committee's proposal which takes it at the Federal rate or the actual experience?

Mr. JACOBS. No, we did not—because if you as a businessman are going out to buy a business and you are willing to pay $100 for that business, you certainly aren't going to think in terms of getting a 4-percent return. If you want a 12-percent return, you take your money and you buy U.S. Government securities. But if you want a

higher return, then you go and you buy a business with a view that you are going to operate that business profitably and earn not less than 20 percent on your money.

If you are looking for 12 percent, you buy Government securities; if you are looking for a 4-percent return, I am not sure what you do.

Chairman RANGEL. Well, I appreciate your offer, and you can rest assured that the members and staff will be taking you up on it.

Mr. Loengard.

Mr. LOENGARD. I am cochairman with Bob Jacobs of the Committee on Reorganizations, and I am merely here to endorse his comments rather than to repeat them.

Chairman RANGEL. We appreciate your contribution.

Mr. Schecter.

STATEMENT OF PAUL A. SCHECTER, CHAIRMAN, SECTION 382 TASK FORCE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. SCHECTER. Thank you, Mr. Chairman. I am Paul Schecter, and I am here on behalf of the American Institute of Certified Public Accountants.

At this particular time, the institute is not joining the bandwagon as projected by the various speakers in regards to the net operating loss concept.

The institute believes that we should deal with old section 382, and work with the various provisions that are presently in section 382, that have been there for 30 years, to try to correct some of the abusive situations.

Let me offer a few comments about the various proposals under consideration. No. 1, we believe that a rate of return on a hypothetical investment of a purchase price does not reflect the net operating loss carryforward of a corporation.

We also have trouble with the definition of "purchase price." What is a purchase price in a closely held situation where there is a merger of two closely held corporations? Doesn't this raise a lot more uncertainty than is presently in section 382?

What about computation of the purchase price where there are convertible debts, or inside liabilities? Should these items be treated as part of the purchase price? These are difficult problems that must be faced when dealing with this new concept of a limitation of NOL's based on purchase price. For example, pages 56 and 57 of the Senate Finance Committee staff proposal for revision of subchapter C and section 382 have a list of 10 special exceptions and special rules to impose on the new section 382.

What is the value of an acquisition if the consideration is in the term of a "junk bond?" How do you determine the purchase price in this that situation? Also, how do you justify a complete limitation of carryovers for a purchase of 51 percent of the stock, when there is no limitation at all in a 50-percent purchase. The purchase of 51 percent results in the same limitation as a purchase of 100 percent control. This lack of graduated approach in the scale-down under a purchase price limitation seems inequitable.

Further, the various proposals currently under consideration do not give credence to a turnaround situation. If a corporation wants to invest cash in another corporation and receive 60 percent of the stock, there is an automatic limitation of the NOL's without regard to the turnaround of the loss corporation into a profitable enterprice.

As can be seen from the experience with section 338, a new concept is not necessarily simpler, fairer or better. There are many hidden problems within a new concept that can be overlooked when a statute is passed. For example, section 338 has given rise to 150 pages of temporary regulations in question-and-answer form which do not even address all the issues raised by the statute. We believe the same problem will occur when attempting to define the new ideas, phrases and terms contained in the various proposals under consideration.

Our recommendations therefore address existing section 382. These recommendations go to the heart of the problems identified by the critics.

Section 382(a) at the present time does not work—it fails to adequately define the continuation of a trade or business, and great uncertainty exists as to when a lost business is continued.

We recommend that section 382(a) be modified to have the period for continuation of a lost business expanded to more than 2 years. Since the present period in section 382(a)(1)(C) was adopted when the carryover period was much shorter than the present 15 years, we recommend the period to continue a lost business also be expanded to 3 to 5 years.

We recommend that the "continuation of a trade or business" be more closely defined in the statute or regulations. We also recommend a definition which uses a three-factor formula looking at the change in the sales of the corporation, the assets of the corporation, and the employees of the corporation. To the extent that these three factors are not reduced by more than 50 percent of historic levels, the purchase should be considered a continuation of the trade or business.

We recommend the addition of certain restrictive provisions to section 382(a) which would disallow a drop-down of active operation, and a sidewise merger or other reorganization of existing subs to bring a profitable operation into a loss operation.

Further, through modification of section 382(a), and section 382(b) the technical problems that presently exist because of "B" reorganizations in section 382(a)(2)(D) could be corrected.

We recognize this is not a panacea, but we like the idea of working with a statute that has been on the books for 30 years. Many say there are tremendous abuses and significant problems in this area. The institute, as accountants working in this area, has not seen any significant abuse or problem.

We feel the turnaround situation must be addressed. We have problems with new cash coming in, when new buyers are coming in, and there is an automatic limitation in regards to the losses.

One of the previous speakers said, the new proposals give some certainty. Well, there is always uncertainty, whether it's negotiations, losses, machinery, or any other aspect of corporate operations—there is always uncertainty involved.

The institute does not believe the new proposals being considered will give the certainty we are looking for. Why should a new plan be adopted where there is so much uncertainty about the underlying concepts and terms?

Thank you.

[The prepared statement follows:]

STATEMENT OF PAUL A. SCHECTER ON BEHALF OF THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. Chairman, Members of the Subcommittee, I am Paul A. Schecter and I am here today on behalf of the American Institute of Certified Public Accountants (AICPA or Institute). The AICPA is the national professional organization of certified public accountants (CPAs) in the United States. Today, the membership consists of over 230,000 CPAs in public practice, in industry, in education, and in government, many of whom work daily with the tax laws.

We appreciate the opportunity to testify at today's hearing regarding the carryover of net operating losses and other tax attributes of corporations.

The problem of how to deal effectively with tax carryovers has been an ongoing one. Proposals to resolve the problem extend from a continuation of current law through what we believe to be radically new alternatives. Obviously, caution must be exercised in this area due to the long-term effects of any changes made.

The AICPA believes that Congress should allow sufficient time to deal comprehensively and completely with overall tax reform and the possible revision of subchapter C before undertaking a revision of section 382. Only after consideration has been given to these major pieces of legislation do we believe that Congress should deal comprehensively and completely with the issue of tax carryovers. We recognize how painful this is for everyone because of the four previous extensions, nevertheless, we suggest that the January 1, 1986 effective date be further extended.

It is universally felt that the 1976 amendment to section 382 was passed without adequate hearings and in our view without adequate consideration of its underlying policies and philosophies. Because of a lack of support for the provision some practitioners and members of Congress feel compelled to do something right away, but this artificial deadline created by a defective code section should not be the driving force for action. We would support a complete repeal of "new section 382." In the event immediate action is felt necessary, we would recommend revising "old section 382" rather than adopting a new approach in this area.

RECENT PROPOSALS

Recent proposals would limit the carryover based on a percentage of the purchase price and are bottomed on two principles: (1) Tax neutrality, i.e., the decision to purchase a corporation should not be influenced by the existence of a net operating loss; and (2) the ratable apportionment of net operating loss usage over an arbitrarily determined period of time, i.e., five or fifteen years.

The rate of return derived from a hypothetical investment of the purchase price bears no relationship to the net operating loss carryforward. It does not represent the invested capital which created the loss. Thus, it does not fairly compensate the seller. We believe that this is an inappropriate basis on which to grant net operating loss survival. The buyer derives a net operating loss carryforward as a benefit without any relationship to the decision to invest additional capital in the losing venture or to completely discontinue its operation. This concept fails to recognize legitimate turn-around situations and the ability to dramatically and quickly rehabilitate a losing venture.

However, the proposals have a certain amount of attractiveness. They are based on a mathematical computation and appear to offer a degree of certainty as to the amount of available loss carryovers. Nevertheless, the proposals have their own complexity and uncertainties. For example, see pages 56 and 57 of the Senate Finance Committee's staff proposal for revision of subchapter C which sets forth numerous special rules and exceptions for their concept of section 382.

The computation of the purchase price, while superficially simple, raises many difficult questions as to whether inside liabilities, the assumption of debt with respect to convertible debentures, options, warrants, or contingent purchase price should be treated as part of the purchase price. In addition, what is the value of an acquisition if the consideration is the form of a "junk bond," or involves a merger of two closely-held corporations. (The proposal does not distinguish between taxable

and tax-free acquisitions.) What is the purchase price in a bankruptcy situation when the creditors step into the shoes of the shareholders?

The proposals would limit a net operating loss carryover based on the quality of the assets in the target corporation. Losses would be denied if there were excessive investment assets or a shell corporation. The quagmire of questions relating to what is an investment asset, whether or not the corporation is in the investment business, whether the purchase price has been inflated as the result of preacquisition contributions to capital, and whether or not losses survive in a shell corporation all present difficult legal and factual issues.

What justification is there to provide a limitation of carryovers following a sale or redemption of 51 percent of the stock but a change of control of only 50 percent would produce no limitation? A sale, redemption or purchase of new stock resulting in a change of control of 51 percent results in the same limitation as a change in 100 percent control. This lack of a graduated approach to the scale-down under a purchase price limitation seems inequitable.

A purchase price limitation for carryovers is a new concept. It is a drastic revision of a code provision that appears to have worked for over 30 years. As can be seen from our experience with section 338, a new concept is not necessarily simpler, fairer or better. Businesses operate best when tax law is static. After more than two years we now have temporary regulations for section 338 in the form of 150 pages of questions and answers that do not even purport to address all the issues raised by the statute. A new concept, no matter how simple the authors believe it to be, will contain many new ideas, phrases and terms which must be defined by regulations.

Many of us would argue that section 334(b)(2), the predecessor to section 338 should have been modified to take care of abusive situations rather than undertake an entirely new provision containing undeveloped concepts. Are we not at the same place with section 382? Where there are perceived abuses, cure them within the framework of a statute that has been on the books for over 30 years.

After reflecting on the problems presented by these proposals, the AICPA Federal Tax Division believes that the Congress should work within the confines of old section 382 before changing to a new concept.

PRESENT LAW AND OUR RECOMMENDED MODIFICATIONS

Present law is divided into two parts: one dealing with taxable transactions (section 382(a)) and the other with tax-free transactions (section 382(b)).

Most of the criticism of existing law has been directed at section 382(a) and not section 382(b). While the latter subsection may have its flaws, we believe they are basically of a technical nature that could be corrected. The criticism of section 382(a) is more fundamental, going to the heart of the philosophy underlying the section.

The basic criticism of section 382(a) is three-fold. First, it encourages uneconomic businesses to be preserved solely for tax reasons. Second, it rests on a concept, continuity of business, that is nearly impossible to administer. Third, it provides a "windfall" to buyers who claim, but do not pay for, loss carryovers.

Before responding to these criticisms, we should examine the policy behind section 382(a). Under the present statute, loss carryovers survive so long as either the old shareholders or the old business remain intact. In other words, it takes changes in both shareholders and business to trigger limitations on loss carryovers. From a theoretical point of view, this policy is reasonable because it permits old shareholders to change businesses, and old businesses to be operated by new owners. The limitations take effect only when new owners change the old business.

However, the critics charge that there is another aspect to the policy behind section 382(a): the implied incentive to keep alive a loss business solely to obtain its tax benefits. We acknowledge the validity of this criticism on a theoretical level in that section 382(a) does not involve a *Libson Shops* rule, i.e., the statute does not require a loss business to be turned around to absorb its own losses. However, we question whether this criticism amounts to much on a practical level. Two years, after all, is a fairly long time to keep alive a failing business. Usually, when the old owners of a failing business have had enough and sell out, it is only after a protracted struggle and the old business is near the end of the line. To keep the kind of business alive for an additional two years is usually burdensome for the new owners, especially if their only interest is in preserving tax attributes and they have no commitment to the old business itself.

However, it may be appropriate for Congress to re-evaluate the length of business continuity test. The present period in § 382(a)(1)(C) was adopted when the carryfor-

ward period was much shorter than the present 15 years. It may be appropriate to extend the business continuity test period to three or five years.

Further, the charge that present section 382(a) promotes the preservation of loss businesses solely for their tax benefits gives a negative and distorted view of the statutory policy. We believe that policy is a positive encouragement to turn around failing businesses. If new owners can succeed where the old owners have failed, the new owners should be permitted to use the old business' losses and be rewarded for their successful efforts. In addition, a transaction solely motivated by tax benefits would be subject to attack under section 269. The reasons for change under the proposals ignore this area of the law.

There is serious criticism, on a practical level, against section 382(a). The charge is that the business continuity test is impossible for the IRS to administer and defies the ability of tax practitioners to advise their clients properly. The reason, of course, is that the statute provides no guidance as to what constitutes a business, nor what constitutes a change in business. We acknowledge this as a serious problem and we would like to offer suggestions for improvement. We think the statute should provide mechanical rules that would measure continuity by reference to three factors: maintaining historic levels of gross income, assets, and employees. We note that the IRS already measures, for advance ruling purposes, the minimum contraction needed to constitute a partial liquidation by reference to the same three factors. If these factors can be used to measure the discontinuance of a business, we think they could serve equally well to measure the converse, the continuation of a business.

Specifically, we propose that a business be considered as continued so long as it has at least 50 percent of its historic levels of gross income, assets, and employees, such levels being determined over some reasonable period preceding the change in ownership, e.g., an average of the last three. In appropriate cases, it might be considered satisfactory to meet two out of three of these factors.

We would permit the acquiring corporation to contribute cash to the loss corporation to pay debts or to acquire trade or business assets. However, we would not allow (1) an infusion of appreciated marketable securities; (2) a contribution of new profitable operations or (3) sidewise tax-free reorganization of profitable corporations previously in the acquiring corporation group.

We believe that the greater certainty resulting from a statutory quantification of the business continuity test would reduce the "windfall" aspect of section 382(a). If buyers can be more confident of satisfying the statute, they would be more willing to compensate sellers for their losses.

As noted above, the bulk of the criticism of existing law is directed at section 382(a) and not section 382(b). We think that reflects the fact that section 382(b) generally works well. Accordingly, we see not reason to make radical changes in this area. We do recognize the existence of certain gaps and inconsistencies in section 382(b) and make the following recommendations:

1. Reorganizations under sections 368(a)(1)(B), (a)(2)(D), and (a)(2)(E) should not be subject to an exception and should be tested at the shareholder level.

2. Indirect ownership (though ownership of another corporation involved in the reorganization) of a loss corporation should be taken into account in testing for continuity of shareholder interest.

These changes are already part of the 1976 version of section 382(b) scheduled to take effect next year and thus could easily be made to existing section 382(b). Also, the 1976 rules relating to Type "B" reorganization could be simplified by testing continuity of shareholder interest solely by reference to the stock of the loss corporartion actually exchanged, unless the stock not so exchanged is subsequently acquired within some reasonable period (say 12 months) following the reorganization.

With regard to the minimum degree of shareholder continuity, we do not support the increase in the minimum level of 40 percent that was enacted as part of the 1976 amendments. On a practical level, the effect of the 1976 rule would be to permit a reorganization of a loss corporation only where it is acquired by a corporation not more than 1½ times its own size. It would seem this size restriction unduly limits the opportunity of a loss corporation to reorganize. We think the 20 percent minimum level of present section 382(b) if fairer, permitting a reorganization of a loss corporation so long as it is acquired by a corporation not more than 4 times its own size, and has not been shown to be abusive.

We recognize that the recommendations we have outlined about are by no means a panacea, but we believe that small steps in the right direction are better than a leap into the unknown.

We want to thank the Committee for the opportunity to express our views.

Mr. FLIPPO [presiding]. Thank you very much for your testimony--all of you.

I would like each of you, or whoever would care to—we would really like for you to comment for the record with regard to section 269, which is an existing tax-avoidance tool.

What would you do with 269? Would you repeal it? Would you leave it alone? What would you do with it?

Mr. SCHECTER. Mr. Chairman, since our position is to retain existing section 382 in a modified form, we would retain section 269. We believe that section 269 is a deterrent to transactions which give rise to tax avoidance.

We would bring the section 269 provisions that are not economically motivated into a definition under section 382, but we would keep section 269 alive and, to the extent possible, make it even stronger.

Mr. ALEXANDER. Mr. Chairman, the Senate Finance Committee staff report—which, by the way, has legislative language embodied in it on pages 186–208 of the report issued on May 20—would provide that section 269 does not apply if new section 382 does apply.

Now, section 269 creates a lot of work for practitioners but does little for either the fisc or the public. We think that the rule that is suggested in the staff report makes much more sense than a continuation of the present overkill and the present uncertainty.

Mr. LEWIS. The American Bar Association's draft, which has been submitted with my statement, would repeal section 269 in the sense that it would make it inapplicable to the area under discussion.

Mr. LOENGARD. The New York State Bar Association also recommends that insofar as section 269 would apply to corporate attributes, which are governed by sections 382 and 383, that it should be repealed. We think that it introduces a subjective element into the law and is random in its application.

And since we feel the new rules adequately govern, correctly govern, the carryover of attributes, we see no reason to have such a subjective provision as an overriding factor in determining whether losses will be allowed after a transaction.

Mr. FLIPPO. I suppose, then, that you would agree that you would have to have a great deal of confidence in 382 to repeal 269.

Mr. LOENGARD. Well, I think 269, as it presently operates, is extremely random in its application. And returning to what Mr. Jacobs said, I think if you leave it in the law it will redound to the benefit of buyers and hurt sellers in the sense that buyers will invoke it as a reason for not paying the going rate, so to speak, for the corporate tax attributes, as allowed by the new statute.

Mr. FLIPPO. Gentlemen, we very much appreciate your testimony; it will be very helpful to us. And we thank you for giving us your thoughts and your time.

Mr. Duncan, I'm sorry.

Mr. DUNCAN. That's OK, I have no questions.

Mr. FLIPPO. I apologize.

Mr. DUNCAN. I will submit them in writing, if I may. Thank you.

Mr. FLIPPO. Our next panel is Kenneth Malek, CPA, chairman of the tax committee, and Jack Salomon, CPA, member of the tax committee, of the Association of Insolvency Accountants.

And also of the Commercial Law League of America, James Chatz.

STATEMENT OF CHARLES M. TATELBAUM, ESQ., COMMERCIAL LAW LEAGUE OF AMERICA

Mr. TATELBAUM. Mr. Chairman, with your permission, I am Charles Tatelbaum, T-a-t-e-l-b-a-u-m. I am a representative of the Commercial Law League of America. Mr. Chatz was unable to come because of the airline strike, and he asked me to come in his stead.

With the Chair's permission, and with that of Mr. Malek and Mr. Salomon, I would like to go first for the basis of continuity of our presentation.

Mr. FLIPPO. I think that will be acceptable, and please proceed.

Mr. TATELBAUM. Rather than regurgitating the printed submission that we have provided to the committee, I would just like to make certain comments.

I am also an associate member of the National Bankruptcy Conference which has helped this committee and the Senate and the House in various proposals dealing with bankruptcy matters.

And while I do not speak for them officially today, I can state that they indicate their support for the statements being made by this panel, and would be very appreciative of the opportunity to work with the committee and staff with respect to any amendments or revisions that need to be made.

Our position basically is—and I am happy to hear that the Honorable Mr. Alexander made the comments earlier—that with respect to insolvency situations in chapter 11, there must be some matters dealt with in whatever legislation has been passed.

The committee need only look at some of the chapter 11 proceedings that are now pending or have been pending in the last few years, and their success in reorganization, which can only be attributable to the unrestricted use of the net operating loss carryforwards, consistent with applicable law. The present law is contained in the Bankruptcy Tax Act of 1980 which was passed, as well as the Bankruptcy Code itself, which has specific provisions dealing with it.

One of the provisions that was new with the Bankruptcy Code in 1978 was the fact that taxpayers now have 6 years from the date of assessment to fully pay their taxes as part of the chapter 11 reorganization. It was consistent with rehabilitating the taxpayer.

If the availability of the NOL to the taxpayer is limited, the service itself will be limited in the recovery of its taxes as a priority or as an unsecured creditor in the chapter 11 proceeding.

The Commercial Law League believes that the present Bankruptcy Tax Act and the Bankruptcy Code adequately deal with the area that we are talking about.

I would like to cite for the committee just two cases or examples you might find.

Recently the case of Wickes Cos. in California was confirmed out of chapter 11. That had over $1.5 billion worth of debt where there was an 80-percent distribution approved by the court. Between 29,000 and 33,000 jobs were saved by that confirmation of chapter

11. I was very active in that case, and I can certainly state that the plan of 80 percent payment to creditors on the average—102 percent in some instances and less than 80 in some others—could never have been effected without the ability of the corporation to utilize tax carryforwards as part of its plan of reorganization.

On the other end of the spectrum, I know of a number of cases, one in particular, involving grain elevators, which are on a much smaller scale, but you have a number of farmers who are very much involved and whose farms are at stake because the grain is simply not there.

In most of these instances you have other grain operators willing to come in and take over the facilities, and pay these farmers some percentage of their debt, only because they have the availability of the use of the NOL in the future. If that were unavailable to them, they would simply wait for the foreclosure sale, take over the elevator, and the farmers in most of these instances would wind up with nothing.

We think that with the court supervision that is there in the chapter 11 proceedings, you eliminate a lot of the cause for concern that is generally expressed with respect to so-called trafficking in NOL's.

We would also suggest to the committee that the Department of Justice has the U.S. Trustee Program, pilot program, throughout the country in various districts. This would be a perfect avenue for investigation by the U.S. trustee as to the need for specific changes or lack of changes dealing with bankruptcy programs. It is a division of the Justice Department and they are consistently involved with it.

Additionally, the National Association of Credit Management has done prior studies on this issue, and when Senator Wallop was dealing with the issue in 1980 they submitted extensive reports, and they, too, have indicated that they would like to work with the committee and the staff in providing information.

The Commercial Law League of America believes that with the issue of bankruptcy and insolvency, it should be treated specially because of the unique nature of it.

Thank you.

[The prepared statement follows:]

STATEMENT OF CHARLES M. TATELBAUM ON BEHALF OF THE COMMERCIAL LAW LEAGUE OF AMERICA

I am Charles M. Tatelbaum, a partner in the Baltimore law firm of Melnicove, Kaufman, Weiner & Smouse, P.A., and I am the head of the Commercial and Insolvency Department of that firm. I am an Associate Member of the National Bankruptcy Conference, a contributing author to *Collier's Bankruptcy Practice Guide*, and am an instructor in Creditors' Rights at the University of Maryland School of Law. I am speaking on behalf of the Commercial Law League of America where I and the League have had the pleasure and opportunity of speaking before various committees of this House in the past. The Commercial Law League of America is an organization comprised of approximately 5,500 members, 80% of whom are attorneys specializing in the areas of commercial and insolvency law.

The Commercial Law League of America appears at this hearing to oppose any changes to the law dealing with the carryover of net operating losses and other tax attributes to corporations only when dealing with situations involving the rehabilitation or reorganization of corporations, usually under the provisions of Title 11 of the United States Code commonly referred to as the Bankruptcy Code. The proposals before this Committee deal with the broad base problem involving carryover of

net operating losses and other tax attributes of corporations. The membership of the Commercial Law League of America deals primarily with the representation of unsecured creditors in protection of creditors' rights. Additionally, our members also deal with representation of secured creditors, as well as debtors, and my comments equally apply to all three areas of representation.

The Commerical Law League of America believes that any changes to the present law dealing with the utilization of net operating loss carryforwards (known as NOLs) that would adversely affect or impact on the reorganization or rehabilitation of an insolvent or bankrupt company will have a detrimental and negative effect on the ultimate recovery by the creditors of the taxpayer. As attorneys and lay persons dealing with the collection of debt in Chapter 11 reorganizations, the League members have found that it is very difficult to secure the additional or outside capital needed for a Chapter 11 entity to reorganize itself. The mere default or extension of debt by a debtor is not sufficient in most instances to affect the reorganization of a troubled debtor. The usual "salvation" in such an instance is where the debtor is able to secure the infusion of additional capital. More often than not, this is facilitated by the prospective investor's contemplated utilization of the NOLs by the debtor entity in the future.

The debtor has clearly suffered the losses which give rise to the utilization of the NOLs. If as part of a court sanctioned reorganization additional capital is secured for the reorganization of the taxpayer by the issuance of new stock, the creditors of the taxpayer should not be caused to suffer. Creditors know that every dollar that must be spent elsewhere by the reorganized taxpayer is a dollar that is not available for distribution. Likewise, a potential investor knows that tax savings will permit a greater investment in the entity and a greater return to the creditor body.

The League believes that the protections afforded to the Internal Revenue Service by the Tax Act of 1980 are sufficient, and any further curtailment of the ability of a taxpayer to utilize the NOL will serve only to frustrate and eliminate the ability of creditors to receive an orderly repayment of their debt. The magnitude of outstanding debt in currently pending Chapter 11 cases is astronomical, and further limitations and frustrations to creditors in collection of that debt will only serve to injure the economy. If the debtor taxpayer is unable to survive because of its inability to secure new capital, the Internal Revenue Service will be unable to collect any taxes at all from the taxpayer. Surely the reorganization and rehabilitation of a taxpayer into an entity which will at some point in the future produce a viable taxpayer is preferable to the elimination of the taxpayer altogether.

In the period of time available, it is impossible to detail the many examples of the need for the utilization of NOLs by debtors undergoing financial reorganization. The League believes that it is vitally urgent that no changes be made to the existing law with respect to the utilization of NOLs involving the rehabilitation and reorganization of financially distressed taxpayers.

Mr. FLIPPO. Thank you very much for your testimony.

Mr. Malek.

STATEMENT OF KENNETH J. MALEK, CHAIRMAN, TAX COMMITTEE, ASSOCIATION OF INSOLVENCY ACCOUNTANTS, ACCOMPANIED BY JACK SALOMON

Mr. MALEK. Thank you, Mr. Chairman. I am pleased to present the views of the Association of Insolvency Accountants today, on whose behalf I am appearing as chairman of the tax committee.

I am a tax partner with Seidman & Seidman, CPA's, where I head up the tax function within their national bankruptcy group.

I would like to start off by giving a brief summary of our recommendations, and first, focus on an important statistic that I would like to bring to your attention. And that is really the level of bankruptcies and business failures that we have seen during the last 3 years.

Based on the report of the President, the most recent publication of it, approximately 87 in every 10,000 businesses failed each year during the 3-year period ended December 31, 1983. And that is

clearly a level of business failure that is higher than anything that we have seen since the Great Depression

Given this, we firmly believe and urge that any legislation in the net operating loss carryover area give very heavy weight to the important economic policy consideration of structuring the legislation in a manner that will help us preserve and rehabilitate these loss companies.

We have heard a lot of very well-reasoned testimony based on the neutrality principle today. And we believe that from a theoretical standpoint it is certainly an excellent approach; however, when looking at the underlying economics of the situation, the net operating loss carryovers are essential to provide an incentive to an outside investor to infuse new capital into a failing loss business.

Let us take, for example, the ABA proposal that was published last February. Under that particular proposal, net operating loss carryovers are limited to 120 percent of essentially the purchase price, or the value of the loss company immediately prior to the change in ownership.

On that basis, let's focus on a company undergoing an insolvency proceeding, maybe even one not in chapter 11, perhaps one that is going through an out-of-chapter-11 debt restructuring. Typically, all of the hard asset value of that company will be eaten up by debt that is left in place in the reorganized or restructured entity.

So essentially what we are taking here is 120 percent of a very small number—and 120 percent of nothing is nothing.

What incentive, then, is there for an outside investor to infuse new capital into a failing business, which funds are then very, very essential for payments to creditors and other essential items—bringing current its long-term debt so that the company can continue to operate out of its existing plant and equipment, and providing a source of working capital to replenish its inventory and overall aid in the rehabilitation of the company?

And so for that reason, the Association of Insolvency Accountants supports—we won't say jump on the bandwagon with the AICPA, but let us say join in the playing of the duet with the American Institute of CPA's, in that we strongly recommend the present law be retained. We certainly are aware that there are a number of potentially abusive transactions, and we would be pleased to work with your committee staff in developing proposals to limit potential abuses, some of which are presented in our written material that we have provided.

But overall we would like to see the approach of old law retained.

Jack, in just a moment, is going to go through some of the rules of old law, how both in the case of the taxable purchase of a company—a new capital infusion—or a nontaxable reorganization—a merger, what have you—there are controls and restrictions under old law that ensure in both types of transactions that the new investor, the new owner of the business, can only succeed to the loss carryovers if the business that produced the losses is in some way rehabilitated and continued.

Certainly we would concur that perhaps the statute should be amended to tighten up what would constitute a continuation of the trade or business for both purposes of a change in ownership by

purchase or a change in ownership by merger or other nontaxable reorganization.

At that point, Jack, would you care to continue?

Mr. SALOMON. Mr. Chairman, distinguished members of the subcommittee, ladies and gentlemen, my name is Jack Salomon and I am a tax partner with the international firm of KMG Main Hurdman. I spend quite a bit of my time working in bankruptcy matters.

The present law, sir, promotes rehabilitation of financially distressed businesses by requiring a continuation of the business. Except for certain types of transactions, which we will address later, most acquisitions of loss corporations are subject to section 382 and related rules. Whether the transaction is structured as a taxable purchase of stock or as a nontaxable corporate reorganization, section 382 and the related provisions generally impose a business-continuity requirement that must be satisfied if the carryovers are to survive the acquisition.

For acquisitions structured as taxable purchases of stock, present section 382(a) requires purchasers to continue the loss corporation's historic business activities. The Treasury regulations indicate that this determination is to be made on the basis of—

> All the facts and circumstances of the particular case. . . . Among the relevant factors [required] to be taken into account are changes in the [loss] corporation's employees, plant, equipment, product, location, customers, and other [significant] items . . .

Acquisitions structured as mergers or other corporate reorganizations generally must qualify as nontaxable reorganizations under the provisions of present section 368. Otherwise, the loss carryovers will not survive the transaction. To qualify as a nontaxable reorganization, regulations promulgated under section 368 require a continuity of business enterprise. Under these regulations, the acquiring corporation must either continue the acquired corporation's business or employ a significant portion of the acquired corporation's business assets in another business.

We believe that these business-continuity tests promote the valid policy objective of allowing the net operating loss carryovers to survive only if the business enterprise of the loss corporation survives. This helps ensure that no investor will receive a significant tax benefit without having rehabilitated the loss corporation's business. In turn, this promotes the reentry of the bankrupt business into the mainstream and preserves jobs in the local community.

In short, sir, don't rehabilitate the company, lose jobs, contract business, and lose the loss—but instead rehabilitate the company, save jobs, expand business, and get the loss.

I have one client situation that I was involved with in the South Bronx. There the company was ready to go under. Why? They didn't have sufficient capital. OK, they went out, they sold stock, they brought in new investors, they kept the same business alive; not only did they keep jobs in the South Bronx, but they created hundreds, literally hundreds, of new jobs for the group known as the "economically unemployable."

Why shouldn't they, using their own losses, get the benefit of these losses to help them restructure their debt, to help them pull

themselves up, to help them regenerate into a new taxpaying good entity?

Section 382, as amended by the Tax Reform Act of 1976, does not encourage rehabilitation of distressed businesses. We believe that the 1976 amendments are overly restrictive in that they reduce carryovers whenever a 40-percentage-point-or-more change in ownership occurs, without regard to whether the business which produced the losses is continued.

In our opinion, a new owner who rehabilitates a loss corporation's business generally should be entitled to the full loss carryovers. Therefore, we believe that the rules of section 382, as amended by the 1976 act, should be stricken from the law prior to their effective date.

With regard to the proposed expansion of limitations under section 382 of the present law, it is true, sir, that a number of transactions escape the limitations of present law section 382. Included among these are additional transactions covered in section 382(a)(1)(C), as amended by the Tax Reform Act; certain partnership arrangements which allocate so-called phantom profits to a corporate partner having substantial loss carryovers; and transactions structured using the *Maxwell Hardware Co.* case.

Our text discusses these points in further detail—we don't have to discuss them now.

In conclusion, the carryovers of a bankrupt or insolvent corporation often are significant "off-balance sheet" assets, facilitating the financial rehabilitation of the company. We strongly urge that the legitimate use of these carryovers, as is available under current law, not be eliminated. A special rule for insolvent companies may be counterproductive in that the courts, which are already overburdened, do not need companies going into chapter in order to benefit from NOL's. All companies that can turn around from loss companies to become profitable companies and create jobs should benefit from their own attributes, including their own net operating losses.

Thank you, sir.

[The prepared statement follows:]

Wednesday, May 22,1985

The Association of Insolvency Accountants ("AIA")
The Commercial Law League of America ("CLLA")

The Honorable Charles B. Rangel (D.,N.Y.)
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Oral Testimony of the AIA and CLLA at the Public Hearing on a Proposal Regarding the Carryover of Net Operating Losses and Other Tax Attributes of Corporations

We are pleased to provide you with the views of the Association of Insolvency Accountants and the Commercial Law League of America, regarding the limitations on corporate net operating loss carryovers following certain changes in ownership. Because of a similarity in the views of these two organizations, we are presenting our testimony on a joint basis, by a panel comprised of the following individuals:

Name, address and Telephone Number	Capacity in which individual will appear and qualifications
Charles M. Tatelbaum, Esq. Melnicove, Kaufman, Weiner & Smouse 36 S. Charles St. Baltimore, Maryland 21201 (301) 332-8514	Appearing as spokesperson of the Commercial Law League of America. Mr. Tatelbaum is a partner with the law firm of Melnicove, Kaufman, Weiner & Smouse, at which he is director of their bankruptcy practice. Mr. Tatelbaum has spoken and written extensively on bankruptcy matters, and is an associate member of the National Bankruptcy Conference.
Mr. Kenneth J. Malek, CPA Seidman & Seidman/BDO Suite 2800 111 East Wacker Drive Chicago, Illinois 60601 (312) 644-7400	Appearing as Chairman of the Tax Committee of the Association of Insolvency Accountants. Mr. Malek is a partner with Seidman & Seidman, CPAs, where he heads up the tax function within that firm's National Bankruptcy Group. Mr. Malek is a frequent speaker on bankruptcy tax matters.

Mr. Jack Salomon, CPA
KMG Main Hurdman
55 East 52 Street
New York, New York 10055
(212) 909-5399

Appearing as a Member of the Tax Committee of the Association of Insolvency Accountants.

Mr. Salomon is a partner with KMG Main Hurdman, CPAs. He has spoken extensively on bankruptcy tax matters and is a co-author of The Tax Aspects of Bankruptcy, Insolvency, and Debt Forgiveness (Prentice-Hall, Inc., Englewood Cliffs, N.J., 1985) and The Tax Consequences of Bankruptcy (American Institute of Certified Public Accountants, New York, N.Y., 1985).

The members of the Association of Insolvency Accountants are involved extensively in the rendering of tax, financial and accounting advice to entities undergoing financial rehabilitation. We are a national organization comprised of members of international firms and local practitioners with recognized expertise in this field.

Summary of Comments and Recommendations

Business bankruptcies and insolvencies reached record levels during the last three years. Based on data from the Report of the President (February, 1985), approximately 87 in every 10,000 businesses failed annually during the period January, 1981 through December, 1983. This represents a failure rate higher than anything this country has seen since the great depression.

Given this dire economic condition, an important policy goal of our country should be the rehabilitation of these businesses, to preserve jobs in the local communities and foster increased competition in the marketplace.

It is normal for a bankrupt or insolvent business to have substantial net operating loss carryovers -- this is a symptom of the disease.

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The factors to be considered in drafting legislation on net operating loss carryovers can be grouped into two major areas:

1. Economic policy considerations, for rehabilitating financially distressed businesses that may have generated substantial loss carryovers; and

2. Tax policy considerations, for restricting abusive utilization of net operating loss carryovers.

In our opinion, the economic policy considerations clearly are the overriding factor.

On February 2, 1985, the American Bar Association adopted Legislative Recommendation No. 1985-1, advocating the limitation of corporate net operating loss carryovers under the "neutrality principle."

We understand that the Subcommittee on Select Revenue Measures may seriously consider drafting legistlation embodying a neutrality approach similar to that taken in Legislative Recommendation No. 1985-1.

We believe that legislation based on the "neutrality principal" would favor tax policy considerations at the expense of the more important economic policy considerations, because such an approach would severely restrict the flow of new capital essential to the rehabilitation of bankrupt, insolvent and other financially distressed corporations.

Consequently, we urge that you retain the approach of present law, which generally allows survival of the losses if the loss business is continued. We recommend that legislation be formulated to close certain potential abuses which may exist.

Why the Neutrality Approach Severely Restricts Legitimate Business Opportunities to Rehabilitate Financially Distressed Businesses

Under the neutrality approach, net operating loss carryovers would be limited to a maximum of 120 percent (or some other percentage) of the value of the loss corporation's equity. For this purpose, the value of the equity is determined at the time of a change in control of the loss corporation.

In the case of a bankrupt or insolvent corporation, typically all hard asset value is offset by debt left in place under the company's plan of bankruptcy reorganization. This results in a very low value for the remaining equity interest, and, as we have stated previously, the 120 percent cap under the neutrality approach is based on the value of that equity interest.

Thus, the neutrality approach would severely reduce the loss carryovers of many corporations undergoing bankruptcy reorganization.

In the typical bankruptcy situation, the financially troubled corporation requires a significant capital infusion:

- o To bring current its long-term debt obligations;
- o To provide a percentage cash pay-out to unsecured creditors; and
- o To provide working capital for rehabilitating its business operations.

In many instances, the troubled corporation must look to an outside equity investor for this capital infusion. Unless the new investor can project a profit from continuing the financially troubled enterprise, there will be no new infusion of capital. The loss carryovers provide a significant enhancement to the new investor's profit projection.

We believe that the reduction of the net operating loss carryovers under the ABA Recommendation would severely limit the outside investor's potential return, and consequently would deter him from infusing the capital needed to rehabilitate the business.

Therefore, we urge that the approach of present-law section 382 be retained, and that legislation be formulated to close potential abuses that may exist.

Present Law Promotes Rehabilitation of Financially Distressed Businesses by Requiring Continuation of the Business

Except for certain types of transactions, which we will address later, most acquisitions of loss corporations are governed by section 382 and related rules. Whether the transaction is structured as a taxable purchase of stock or as a nontaxable corporate reorganization, Section 382 and the related provisions generally impose a business continuity requirement that must be satisfied if the carryovers are to survive the acquisition.

For acquisitions structured as taxable purchases of stock, present section 382(a) requires purchasers to continue the loss corporation's historic business activities. The Treasury regulations indicate that this determination is to be made on the basis of "all the facts and circumstances of the particular case... . Among the relevant factors [required] to be taken into account are changes in the [loss] corporation's employees, plant, equipment, product, location, customers, and other [significant] items... ." [1]

Acquisitions structured as mergers or other corporate reorganizations generally must qualify as nontaxable reorganizations under the provisions of present section 368. Otherwise, the loss carryovers will not survive the transaction. To qualify as a nontaxable reorganization, regulations promulgated under section 368 require a continuity of business enterprise. Under these regulations, the acquiring corporation must either (1) continue the acquired corporation's business or (2) employ a significant portion of the acquired corporation's business assets in another business.[2]

We believe that these business-continuity tests promote the valid policy objective of allowing the net operating loss carryovers to survive only if the business enterprise of the loss corporation survives. This helps ensure that no investor will receive a significant tax benefit without having rehabilitated the loss corporation's business. In turn, this promotes the re-entry of the bankrupt business into the mainstream, and preserves jobs in the local community.

Section 382 as Amended by the Tax Reform Act of 1976 Does Not Encourage Rehabilitation of Distressed Businesses

We believe that the 1976 amendments are overly restrictive, in that they reduce carryovers whenever a 40 percentage point or more change in ownership occurs, without regard to whether the business which produced the losses is continued.

In our opinion, a new owner who rehabilitates a loss corporation's business generally should be entitled to the full loss carryovers. Therefore, we believe that the rules of section 382 as amended by the 1976 Act should be stricken from the law prior to their effective date.

Proposed Expansion of Limitations Under Section 382 of Present Law

It is true that a number of transactions escape the limitations of present-law section 382. Included among these are:

- o the additonal transactions covered in section 382(a)(1)(C), as amended by the Tax Reform Act of 1976;
- o certain partnership arrangements which allocate so-called "phantom profits" to a corporate partner having substantial loss carryovers; and
- o transactions structured using the Maxwell Hardware Co. case.[3]

We believe that the scope of present-law section 382 should be broadened as follows:

(1) Transactions covered in section 382(a)(1)(C), after the 1976 amendments. Under present-law section 382(a), the transactions taken into account in determining whether a 50 percentage point or more change in ownership has occurred are limited to "purchases" and redemptions. They should be expanded to cover the additional transactions addressed in section 382(a)(1)(C) as constituted after the 1976 amendments. Thus, for example, it would no longer be possible to qualify a change in control of a corporation under section 351, to discontinue the old loss business and to offset loss carryovers against profits from an unrelated new business.

This expansion will encourage the desired rehabilitation of financially distressed businesses, by eliminating a "loop-hole" under which the distressed business could be discontinued without reduction of the loss carryovers.

(2) Certain partnership arrangements. Recently, a number of loss corporations have formed joint ventures with profitable businesses. Typically, management or some other investor group has formed a partnership ("Buyer Partnership") to acquire a profitable corporation in a leveraged buy-out transaction. A corporation with substantial net operating loss carryovers ("Loss Corporation") is included as a partner in Buyer Partnership. Loss Corporation is allocated a high percentage (say, 90 percent) of Buyer Partnership's profits until the principal amount of the debt incurred in the leveraged buy-out is paid off. Naturally, these profits are so-called "phantom profits" because the related cash is fully absorbed by principal payments on the debt.

After the principal is paid off, Loss Corporation's share of profits is reduced to a very low percentage (say, 10 percent).

Loss Corporation's partnership capital account accumulated from the allocation of phantom profits is paid-off on a deferred basis, out of subsequent cash flow.

We believe this transaction can be abusive, unless the deferred pay-off of Loss Corporation's capital account is computed with a reasonable rate of interest.

However, because a partner's capital account is not a debt instrument, we do not consider it necessary to impose the applicable federal rates (under the 1984 Tax Reform Act) on this particular transaction, and believe that a seven-percent rate (compounded) should be sufficient.

(3) Transactions structured under the Maxwell Hardware Co. case. The taxpayer in this case used a special class of preferred stock to avoid a fifty-percentage point or more change in ownership under section 382(a). This enabled the company to offset the profits from an unrelated business against loss carryovers. We recommend that the Treasury be authorized to promulgate regulations under which priorities and preferences as to future distributions of earnings and assets would be taken into account in determining whether a fifty-percentage point or more change in ownership has occurred.

Conclusion

The carryovers of a bankrupt or insolvent corporation often are significant "off balance sheet" assets, facilitating the financial rehabilitation of the company. We urge that the legitimate use of these carryovers (as is available under current law) not be eliminated.

[1] Treasury regulation section 1.382(a)-1(h)(5).
[2] Treasury regulation section 1.368-1(d)(2).
[3] Maxwell Hardware Co. v. Commissioner, 343 F.2d 713 (9th Cir., 1965).

Mr. FLIPPO. Thank you very much. You make some forceful arguments in regard to carryovers of losses. I wonder if you would support a limitation on the continued transfer of the loss when corporation A buys a loss of corporation B, buys that corporation.

You speak about rehabilitation. Would you support a limitation on a further transfer of that corporation?

Mr. MALEK. We would support such a limitation only in the event there would be a significant change in business in connection with and as a consequence of that subsequent transfer.

Mr. SALOMON. As I said in my testimony, sir, if it's the same people that are working, the same jobs, the same suppliers that we are using, the same customers being serviced, why, simply because somebody else happens to now own them, somebody who may have some area of expertise that the old owners didn't have—why should they lose these benefits? It's the company's benefits. Why shouldn't the company be permitted to retain its own benefits?

If you change the structure of the company, if you play games and do what we would call trafficking and not keep the same company, why should you have those losses? They are not yours, you didn't lose the money, you didn't incur the problems. Why should you benefit from the tax law which says he who incurs losses may benefit from them?

Mr. TATELBAUM. I think from a legal standpoint, if I may, Mr. Chairman, we would have no objection to adequate safeguards to prevent the abuses that are now perceived to happen in so-called trafficking. Our concern is the repayment of debt and the continued viability of the company, especially from our standpoint of the repayment of debt.

If safeguards were to be imposed that would eliminate the abuses but at the same time permit the continued viability, we would support them, as long as the concerns of the future operations were addressed.

Mr. MALEK. If I may add briefly, Mr. Chairman, it's important, if we do go in the direction of carving out an exception for bankrupt companies, that that exception be a very broad-based one.

The drafts of the neutrality approaches that I have seen thus far have limited exceptions for insolvent companies to the situation where stock is exchanged for outstanding debt. That merely funds an internal reorganization of the company; it does nothing to infuse new capital that is needed to rehabilitate the business.

What is often essential in these cases, in order to bring the company out of chapter 11, is to get in a very significant chunk of cash from an outside investor and give him a 50- or 80-percent interest in the company. And only then can you bring capital in to rehabilitate the business, pay off the unsecured creditors on some sort of cents-on-the-dollar basis, and hopefully create an ongoing, viable business enterprise that perhaps, absent the ability to utilize the net operating loss carryovers, might well have been liquidated.

Mr. FLIPPO. I see. Mr. Duncan?

Mr. DUNCAN. Do you have any statistics to show how many companies actually survive that you are——

Mr. MALEK. Yes. Those statistics, as I recall, are developed by the Office of the U.S. Trustee. We spoke with them informally yesterday evening, for that matter, on this very point, and I think, as Mr.

Tatelbaum has suggested, perhaps they should be called in to do some sort of a study, perhaps limited, perhaps in greater depth, as to exactly what the benefits of net operating loss carryovers are in terms of numbers of companies brought out of chapter 11 on a successful basis.

Mr. DUNCAN. Well, you told me a lot, but you didn't answer my question.

Have a lot of companies survived? It's been my impression that very few have survived, but I don't have——

Mr. MALEK. There are different types of bankruptcy cases. The ones that I am involved in as a tax partner with my firm are the ones where there is a chance to bring out the business, to help it survive through enticing an outside investor, for both economic reasons, because he has to turn the business around, and tax reasons, to infuse capital into the business. I see a great number of those cases. My firm, however, has not developed actual statistics on that.

Mr. DUNCAN. Would you say you had more survive than did not survive?

Mr. MALEK. Yes.

Mr. TATELBAUM. If I may, I think we have to look at the types of chapter 11's that are filed. I think it's admitted that more fail than make it; I don't think there is any question, and the Administrative Office of the Courts has full statistics on it.

I believe what we are saying, at least from the Commercial Law League standpoint, Mr. Chairman, as attorney, many of those should not even be in chapter 11 to start with, and that is something that has been addressed partially in the 1984 amendments to the Bankruptcy Code, and which appear to be very successful at this point in addressing that issue.

The ones that do make it make it very formidably in part because of the use of the tax loss carryforwards. I think the elimination of the use of it will further curtail those companies coming out of chapter 11 that should.

Mr. DUNCAN. You look like you want to say something.

Mr. SALOMON. In my experience, sir, I only get involved heavily in those companies that do make it. And, again, having its own losses available, its own attributes available to use during its period when it is still struggling trying to get back on its feet out of the quicksand—that's what helps it make it.

Mr. DUNCAN. Do you think 15 years is too long to preserve those benefits?

Mr. SALOMON. No, sir.

Mr. DUNCAN. I'm sure you'd say no, too, wouldn't you?

Mr. TATELBAUM. I would like to say no, but in all candor I think if limitations were imposed that were realistic with respect to this type of situation, it would not be totally repugnant to the whole philosophy. I would like to see the continued use of 15 years, because it gives the company the rehabilitation time it needs. But in candor, I think maybe some minor limitation wouldn't hurt.

Mr. MALEK. If I may, I have one additional comment. If a company typically doesn't use a substantial portion of the carryovers by the end of 6 or 7 years, it is not going to be around to see the end of the 15th year anyway.

Mr. SALOMON. It's giving it something which it can use if it's coming around slowly and doing well. But, again, either it will use it within 5 or 6 years, or it won't be around much longer.

Mr. DUNCAN. You have certainly given us a lot to think about. Thank you very much for your contribution.

Mr. MALEK. We certainly appreciate the opportunity to have presented testimony today.

[The following was subsequently received:]

THE ASSOCIATION OF INSOLVENCY ACCOUNTANTS,
Minneapolis, MN, June 21, 1985.

Mr. JOSEPH K. DOWLEY,
Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, Longworth House Office Building, Washington, DC.

DEAR MR. DOWLEY: We are pleased to provide you with our additional views in connection with the testimony submitted on May 22, 1985, at the public hearings on net operating loss carryovers.

SUMMARY OF PRIOR TESTIMONY

The factors to be considered in drafting legislation on net operating loss carryovers can be grouped into two major areas:

(1) Economic policy considerations, for rehabilitating financially distressed businesses that may have generated substantial loss carryovers; and

(2) Tax policy considerations, for restricting sales of net operating losses.

At the hearing, we called the Subcommittee's attention to the record level of business failures during the past three years. Given this serious economic condition, we urged that the economic policy considerations be given the over-riding weight in drafting legislation in this area.

(1) Bankrupt, insolvent and other financially distressed companies typically generate significant net operating losses and other tax attribute carryovers. The retention of these carryovers following a change in ownership is essential to attract capital required for rehabilitating these continuing businesses.

(2) Many individuals testifying at the hearing advocated amending the rules on survival of carryovers under an approach called the "neutrality principle." Under this principle, net operating loss carryovers generally would be limited to a percentage of the equity value of the loss corporation immediately prior to the change in ownership.

(3) In the case of bankrupt, insolvent or other financially distressed corporations, effectively all hard asset value is offset by debt left in place after financial restructuring. This results in a very low value for their equity prior to the new capital infusions needed for rehabilitation. As a consequence, the net operating loss carryovers of these companies would be virtually eliminated under the neutrality principle.

(4) Based on the foregoing, we urged that the general approach of present-law § 382 be retained, and that legislation be formulated to close certain potential abuses which we discussed.

A photocopy of our prior written testimony is attached for your convenience.

SUMMARY OF ADDITIONAL RECOMMENDATIONS

A summary of our additional recommendations, in connection with the testimony submitted at the hearing, is as follows:

(1) If the proposed legislation will adopt the neutrality principle, we urge, at a minimum, that the legislation include a blanket exemption for bankrupt and insolvent corporations. Corporations undergoing out-of-court workouts also should be exempt.

(2) We recommend that the exemption described in item (1) above not be limited to the extent of a corporation's insolvency.

(3) We recommend that the Subcommittee not adopt the restriction on deductibility of interest payments advocated by certain individuals testifying at the hearing.

(4) We recommend that the continuation of business test (of present law) generally be retained for *all* corporations, and that the approach of the neutrality principle be abandoned. In connection with this, we suggest that present law be expanded to require continuation of business (generally within the meaning of § 1.382(a)-1(h) of the Treasury regulations) for tax-free reorganizations and all other changes in control.

The reasons underlying each additional recommendation are explained in the discussion which follows.

BLANKET EXEMPTION FOR BANKRUPT AND OTHER FINANCIALLY DISTRESSED CORPORATIONS

As mentioned previously, the neutrality approach would limit net operating loss carryovers based on the value of the equity interest prior to a change in control. The following example illustrates the potential severity of this limitation:

Example: Assume loss corporation has net operationg loss carryovers totalling $4,000,000. Further assume that the going-concern equity value of loss corporation, before considering tax benefits, is as follows:

Going-concern value of assets	$5,000,000
Less liabilities	(4,500,000)
Equity value before tax benefits	500,000

Under the American Bar Association's version of the neutrality principle,[1] for instance, net operating loss carryovers would be limited to a maximum of 120 percent of the value of the loss corporation's equity (including value of tax benefits), with the 120-percent cap phased in over the 60-month period following a change in ownership. During this period, the net operating loss carryovers would be available to offset taxable income at the rate of two percent of the equity value per month, on a cumulative basis.

Under the ABA Recommendation, a purchaser anticipating maximum utilization of the carryovers would value them as the present value of an annuity for 60 months of the product of the following:

(a) 2 percent (the maximum utilization rate per month); times

(b) 46 percent (the maximum corporate tax rate); times

(c) the sum of (1) the value of the tax benefits plus (2) $500,000 (the equity value before tax benefits).

Using an 18 percent hypothetical discount rate, solution of the simple algebraic equation would place a value of $284,066 on the carryovers. Utilization of the net operating loss carryovers would be limited to $940,879. [120 percent x (500,000 + 284,066)]. In other words, of the $4,000,000 net operating loss carryovers, $3,059,121 effectively would expire.

As mentioned in our prior testimony, many troubled corporations must look to outside equity investors for the capital infusions needed to revitalize their businesses. The severe reduction of net operating loss carryovers illustrated in the example above would reduce significantly the outside investor's return, and could deter him from infusing the needed capital.

If the proposed legislation adopts the neutrality principle, we urge, at a minimum, that such legislation include a blanket exemption from such principle for bankrupt and insolvent corporations.

We also recommend that the blanket exemption be extended to corporations undergoing certain workout arrangements outside of formal bankruptcy proceedings. We believe this extension is essential to relieve pressure on the bankruptcy courts, whose present case dockets are highly overloaded. Were the blanket exemption limited to corporations undergoing formal bankruptcy and insolvency proceedings, there would be a clear incentive for loss corporations to file for otherwise-unnecessary chapter 11 protection.

For purposes of the extension to workout proceedings, we recommend that your Subcommittee adopt a definition of "qualified workout" based in general on that contained in § 108(e)-(10)(C)(ii) of the Internal Revenue Code. Section 108(e)(10)(C) provides as follows:

"(C) Exception for transfers in certain workouts—

(i) In general—Subparagraph (A) shall not apply to any transfer of stock in a qualified workout.

(ii) QUALIFIED WORKOUT—For purposes of clause (i), the term "qualified workout" means any plan under which stock is transferred to creditors in satisfaction of indebtedness if—

(I) because of cash flow and credit problems, the corporation making such transfer will have trouble in meeting liabilities coming due during the next 12 months to

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[1] See ABA Legislative Recommendation No. 1985-1, attached as an exhibit to the testimony of Mr. James B. Lewis.

such an extent that there is a substantial threat of involuntary proceedings relating to insolvency or bankruptcy,

(II) such corporation in any report to its shareholders for the period during which such transfer occurs includes a statement that such corporation believes it meets the requirement of subclause (I) and that it is availing itself of the workout provisions of this subparagraph,

(III) the holders of more than 50 percent of the total indebtedness of the corporation approve such plan, and

(IV) at least 25 percent of the total indebtedness of the corporation is extinguished by transfers pursuant to such plan."

BLANKET EXEMPTION SHOULD NOT BE LIMITED TO THE EXTENT OF A CORPORATION'S INSOLVENCY

At least one individual testifying at the hearing recommended that the exemption for bankrupt and insolvent companies be restricted to the extent of a corporation's insolvency. The end result of such proposal would be to allow insolvent corporations unrestricted use of a portion of their loss carryovers. The unrestricted portion would be the amount of losses financed with debt capital. The portion financed by equity capital would be limited severely, under the rules illustrated in the example above.

We urge that the Subcommittee not adopt the proposal limiting the exemption to the extent of insolvency for the reasons shown on the following page:

(1) Even if unrestricted use of loss carryovers is limited to the portion financed with debt capital, we believe that such unrestricted use is appropriate only if the business enterprise of the loss corporation (i.e., the products, employees, etc.) is continued. This objective could be achieved through continuation of the present law, with certain modifications discussed later.

(2) We believe that the economic policy objective of encouraging the rehabilitation of financially distressed corporations would be best achieved if the entire amount of loss carryovers (not limited to the portion financed by debt capital) were available to new owners, provided they continue and rehabilitate the loss corporation's business enterprise.

INTEREST DEDUCTIONS SHOULD NOT BE DISALLOWED

Certain individuals testifying at the hearing recommended a limitation on interest deductions when a loss corporation exchanges stock for its outstanding debt. Under their recommendation, interest deductions could be disallowed for interest paid in cash to a creditor within three years prior to the date as of which the creditor exchanges his debt position for an equity interest in the corporation.

We believe that your Subcommittee should not adopt the proposals for disallowing interest deductions for the following reasons:

(1) The disallowance would apply primarily to stock-for-debt exchanges outside of formal bankruptcy proceedings. Section 502 of the Bankruptcy Code disallows claims for interest accruing after the commencement of a bankruptcy case, except in certain cases when the value of collateral is sufficient. Consequently, with the terms of many bankruptcy cases exceeding two and even three years, it is doubtful that the recommendation to disallow interest deductions would net for the Treasury any significant revenues with respect to corporations undergoing formal bankruptcy proceedings.

(2) The limited application (i.e., primarily to corporations outside of formal bankruptcy proceedings) suggests that the provision to disallow interest deductions may be an unwarranted complication of our tax system.

(3) The mere fact that interest is paid in cash during a period of financial difficulty is a conclusive indication that the related debt obligation is in fact debt and not equity.

EXPANSION OF BUSINESS-CONTINUITY TEST

We believe that new owners of a loss corporation should reap the benefits of the loss carryovers only if they rehabilitate and continue the loss corporation's business.

Present law contains a business continuity test for both (1) taxable purchases and redemptions of stock described in § 382-(a)(1)(B) (hereinafter "taxable changes in ownership"), and (2) certain nontaxable reorganizations specified in § 382(b)(1) (hereinafter "tax-free changes in ownership").

The business-continuity test for taxable changes in ownership is prescribed by Treasury regulation § 1.382(a)-1(h). Under the regulation, "all the [relevant] facts and circumstances of [a] particular case [are] taken into account. Among the rele-

vant factors . . . are changes in the corporation's employees, plant, equipment, product, location, customers, and other items which are significant in determining whether there is, or is not, a continuity of the same business enterprise."

The business-continuity test for tax-free changes in ownership is prescribed by Treasury regulation § 1.368-1(d). The business-continuity rules for tax-free changes in ownership are less stringent and less detailed than the rules for taxable changes in ownership. For tax-free changes in ownership, the acquiring corporation must either (1) "continue the acquired corporation's . . . business" or (2) employ "a significant portion of the [acquired corporation's] business assets in a business. [Emphasis added]." If the acquired corporation "has more than one line of business, continuity of business enterprise requires only that [the acquiring corporation] continue a significant line of business." If the loss corporation is the acquiring corporation in a transaction constituting a tax-free change in ownership, there is no requirement that the historic business of the loss corporation be continued.

We recommend that you expand the present business-continuity test for taxable changes in ownership to all other changes in ownership, if there is a change in control of the loss corporation of 50 percentage points or more. In the case of tax-free changes in ownership, the business-continuity test should apply to any corporate party to the reorganization having a loss carryover and experiencing a 50 percentage point or more change in control.

This expansion of the business-continuity test would achieve both the economic policy objectives and the tax policy objectives of legislation on net operating loss carryovers. By requiring continuation of the business which produced the losses, the expanded test would promote the rehabilitation of distressed businesses and would prevent the sale of losses by shell corporations.

Based on the foregoing, we recommend that the approach of the neutrality principle be abandoned and that the revised business-continuity test be made applicable to all loss corporations. The revised business-continuity test should not be a limited rule applying only to bankrupt and insolvent corporations. If the test were so limited, it would encourage some loss corporations to file for otherwise-unnecessary chapter 11 protection, which would place an excessive burden on our country's bankruptcy system.

CONCLUSION

We appreciate this opportunity to submit additional written testimony concerning possible new legislation on net operating loss carryovers.

We would be pleased to discuss our additional recommendations with you or your staff. Please contact either Kenneth Malek (at 312-644-7400) or Jack Salomon (at 212-909-5399), of our Tax Committee.

KENNETH J. MALEK,
Chairman of the Tax Committee.

Mr. FLIPPO. We appreciate your testimony, it will be very helpful.

Thank you.

The committee stands adjourned, subject to the call of the Chair.

[Whereupon, at 11:42 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF FRANK E. MCGRATH, ASSISTANT VICE PRESIDENT, TAXES AND RISK MANAGEMENT, CENTEL CORPORATION, CHICAGO, IL

Mr. Chairman and members of this Subcommittee, my name is Frank E. McGrath. I am Assistant Vice President—Taxes and Risk Management for Centel Corporation, and have served in this capacity for approximately six years. Prior to joining Centel, I was a Tax Manager with the public accounting firm of Arthur Andersen & Company.

I am testifying today as a representative of Centel Corporation.

Centel Corporation is a publicly-held, diversified telecommunications company with over 50 subsidiary corporations. Centel, headquartered in Chicago, operates local exchange telephone systems in ten states, cable television in eight states, and is a nationwide provider of business communications system and materials for the telecommunications industry, and supplies videotex and teletext services.

CARRYOVER OF TAX ATTRIBUTES

In announcing these hearings, the Chairman requested comments to:

(1) Repeal the rules in favor of existing Section 382;
(2) Let amended Code Section 382 enacted in 1976 become effective; or
(3) Adopt different rules.

For compelling business, economic and tax policy reasons, which I will discuss, I urge the Chairman and members of the Subcommittee to: Repeal the rules enacted under the Tax Reform Act of 1976, in favor of existing Code Section 382.

Centel Corporation has been involved in over 40 business acquisitions in the last six years. The decision to acquire a company is never lightly made and involves numerous considerations.

The acquiring corporation must examine and weigh a company's profit potential, its compatibility with existing businesses and markets, contingent liabilities, shareholder interests, loan agreements and various securities law requirements. Tax factors and attributes, while a concern, are nevertheless secondary. They generally neither motivate, nor are fatal to, a proposed business combination.

Although trafficking in loss carryovers and other attributes may have existed as an abuse at one time, the simple fact today is that the decision to acquire a business is a multifaceted economic decision. With volatile interest rates and rapidly escalating costs of doing business, acquisition tax benefits are only one of many concerns.

Based upon my role in Centel's acquisition program, I can assure the Subcommittee that corporate officers impute a value to *all* aspects of an acquisition candidate to test the validity of the proposed purchase price. No premium is paid merely for tax attributes. The perceived abuse of trafficking in losses is, I believe, a myth in today's economic climate.

From a policy standpoint, the goal of new legislation should be the protection of governmental interests without closing the door on all potential acquisitions. Mechanisms are already in place to discourage corporate tax avoidance in acquisitions. Code Section 269 restricts the carryover and use of tax attributes where tax avoidance is the principal purpose of an acquisition and expressly gives the Secretary of the Treasury broad discretion to disallow deductions, credits or other allowances.

Where Congress has enacted a specific provision, namely Code Section 269, whose *sole* function is to deal with tax avoidance, additional provisions to serve the same purpose are totally unnecessary. I urge the members of this Subcommittee to reject redundant measures which are legislative overkill.

Mindful, however, of the established congressional policy of curbing tax avoidance acquisitions, I respectfully submit that existing Code Sections 382 and 269 are sufficient deterrents to such trafficking. No other alternative could accomplish a greater end than can be achieved under either existing Code Section.

SUMMARY

For the reasons outlined above, I recommend that:

The rules enacted under Section 382 in the Tax Reform Act of 1976 be repealed; and

Existing Section 382 be continued in its present form.

TEXAS A&M UNIVERSITY
COLLEGE OF BUSINESS ADMINISTRATION
COLLEGE STATION, TEXAS 77843-4353
409-845-5014

Department of
ACCOUNTING

May 9, 1985

Honorable Charles B. Rangel
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth Building
Washington, D.C. 20515

Re: Hearings on Carryover of Net Operating Losses

Dear Representative Rangel:

The principal problem with present tax law on NOL carryovers is that it creates an asset (the NOL carryover, which is a potential offset against future taxed income) that may or may not be utilized and that could benefit new shareholders. The response of tax policymakers is that there should be no trafficking in NOL carryovers, which response is not completely effective and is certainly complicated. However, preventing trafficking in NOL carryovers discriminates against corporations which do not have diverse business activities or a prior history of profitable operations. If the anti-trafficking policy were administered fairly, a NOL carryover would be determined for eacn segment of a corporation with diverse operations and could only be offset against future profits of that segment.

A solution for NOL carryovers which is relatively simple, which prevents trafficking, and which gives substantial equity, is to permit a refundable credit for NOLs which do not offset income of the current and prior years in place of a carryover. Such a credit is discussed in the attached article "Operating Losses in Corporate Acquisitions," 25 Tax Notes 1249-1251 (Dec. 24, 1984). I recommend the refundable credit for Congress' consideration and adoption.

If I can be of further assistance, please let me know.

Sincerely,

L Bravenec

Lorence L. Bravenec
Thomas W. Leland Prof. of Accounting
Director, Graduate Tax Program

OPERATING LOSSES IN CORPORATE ACQUISITIONS

by Lorence L. Bravenec

Lorence L. Bravenec is professor of accounting at Texas A&M University in College Station, Tex. In this article, he suggests the adoption of a refundable credit for corporations' operating losses. Bravenec says that the treatment of operating losses is "the most intractable problem" in corporate taxation. Any solution, he says, should satisfy the criteria of simplicity, substantial equity, and the prevention of trafficking in losses. He concludes that a refundable credit satisfies these aims and would also be beneficial from a broader economic and financial perspective.

The most intractable problem in corporate taxation is now the treatment of corporation operating loss carryovers after ownership changes. This problem has become the Gordian knot of corporation taxation, with no solution presently acceptable to policymakers.

Under the current federal income tax law, corporation expenses produce tax benefits only in offsetting income. That is, there is a net earnings requirement for utilization of corporation deductions. The net earnings requirement is relaxed to some extent through the ability of a corporation to carry over its operating losses and apply them against past and future income. However, if ownership of the corporation changes, restrictions are placed on use of such operating losses.

The current restrictions on operating losses are a technical maze, understandable only by those high priests of the tax profession—Philadelphia tax lawyers, Cleveland tax accountants, and their kindred. Lest the reader doubt the verity of that statement, let him/her review the operative part of the current provision:

"Section 382. Special Limitations on Net Operating Loss Carryovers

"Effective for tax years beginning after 1985, for reorganization plans adopted after 1985.

"(a) Certain Acquisitions of Stock of a Corporation.—

(1) In General.—If—

(A) on the last day of a taxable year of a corporation,

(B) any one or more of the persons described in paragraph (4)(B) own, directly or indirectly, a percentage of the total fair market value of the participating stock or of all the stock of the corporation which exceeds by more than 60 percentage points the percentage of such stock owned by such person or persons at—

(i) the beginning of such taxable year, or

(ii) the beginning of the first or second preceding taxable year, and

(C) such increase in percentage points is attributable to—

(i) a purchase by such person or persons of such stock, or of the stock of another corporation owning stock in such corporation, or of an interest in a partnership or trust owning stock in such corporation,

(ii) an acquisition (by contribution, merger, or consolidation) of an interest in a partnership owning stock in such corporation, or an acquisition (by contribution, merger, or consolidation) by a partnership of such stock,

(iii) an exchange to which section 351 (relating to transfer to corporation controlled by transferor) applies, or an acquisition by a corporation of such stock in an exchange in which section 351 applies to the transferor,

(iv) a contribution to the capital of such corporation,

(v) a decrease in the amount of such stock outstanding or in the amount of stock outstanding of another corporation owning stock in such corporation (except a decrease resulting from a redemption to pay death taxes to which section 303 applies),

(vi) a liquidation of the interest of a partner in a partnership owning stock in such corporation, or

(vii) any combination of the transactions described in clauses (i) through (vi),

then the net operating loss carryover, if any, from such taxable year and the net operating loss carryovers, if any, from prior taxable years to such taxable year and subsec-

The current restrictions on operating losses are a technical maze, understandable only by those high priests of the tax profession—Philadelphia tax lawyers, Cleveland tax accountants, and their kindred.

quent taxable years of such corporation shall be reduced by the percentage determined under paragraph (2).

(2) Reduction of net operating loss carryover.—The reduction applicable under paragraph (1) shall be the sum of the percentages determined by multiplying—

(A) by three and one-half the increase in percentage points (including fractions thereof) in excess of 60 and up to and including 80, and

(B) by one and one-half the increase in percentage points (including fractions thereof) in excess of 80.

The reduction under this paragraph shall be determined by reference to the increase in percentage points of the total fair market value of the participating stock or of all the stock, whichever increase is greater."

Many a lawyer or accountant has expended considerable intellectual sweat in the initiation rites of the statutory law, not to say of the administrative and judicial interpretation.

The obvious solution . . . is to give corporations current tax benefit from operating losses which do not currently offset prior years' income.

Unfortunately, the current state of the law puts a premium on sophisticated tax advice, and thereby punishes the unwary and innocent. The current law also is a financial boon to tax lawyers and accountants who understand it and a malpractice threat to those who don't.

Policymakers and their advisors are divided into two camps—those who favor restrictions on operating loss transferability and those who don't. Those who favor restrictions dislike the prospect of there being trafficking in losses through the acquisition of carryover corporations, while those who favor transferability point to the inequity of not allowing any benefit from an operating loss carryover.

Perhaps both camps can be satisfied. But let's first isolate criteria that we'll use to evaluate any solution. *Simplicity.* This is a talisman to which many policymakers bow today, and not without reason. If the tax laws can be understandable by the mass of professionals who give advice, have we not done all affected taxpayers a favor, by cutting down professional fees and by sharply reducing the prospect of error? Under this criterion, any solution which permits operating loss carryover only under restrictions after transfer of ownership is bound to be found wanting.

A second criteria is to *prevent trafficking* in losses. "Trafficking in losses" has an unpleasant sound, and we must be careful not to oppose it for that reason. However, there is a clear policy reason to be against "trafficking," whether we use pleasant or unpleasant words to describe the phenomenon. The phenomenon is that unrestricted transferability, or trafficking, promotes decision making on the basis of tax factors which have no purpose that is good other than to make use of the operating loss carryovers. In other words, trafficking will bend taxpayers out of shape, will force them to make otherwise undesirable choices, and will punish those who might be unwilling to "traffic." Surely, there is a solution which will permit use of operating losses without the accompanying trafficking, in which the affected corporation and its shareholders can benefit from an operating loss without having to sell it as a carryover by selling the corporation.

A third criterion is *substantial equity.* The income tax on business income should apply to the value created in the production and distribution cycle. The role of business deductions is in effect to make an allocation of the value created in the process so that the value created (or value added) is taxed once, but only once. Transactions creating business deductions generally give rise to correlative income recognition to other taxpayers, either currently or at some other time, and thereby result in a single taxation of the volume produced. If there is no tax benefit from business deductions, then there is a double tax on value created.

Let's use an example to explain the concept of substantial equity. If two concerns sell a service for $100, but one produces the service at a total cost in salaries of $90 and the other at a total cost of $110, a double tax on $10 will be imposed on the activity of the second concern if there is no tax benefit from its $10 loss. Similar observations could be made about a business which deals in inventories or which makes use of depreciable assets—prior value was created and produced taxable income to some person, and the denial of tax benefit to a taxpayer from such costs results in a type of double taxation.

Further, if a concern's tax benefit of deductions is postponed, it loses some, and in many cases a substantial portion, of the value of the deductions. For example, assume that a firm has to wait seven years to use a $100 operating loss. At 10 percent, the discounted present value of the deduction is only $51.

The credit rate should be set at a rate which, in the absence of special considerations, approximates the rate on taxed income . . . which might be offset in the future.

Further, current laws clearly discriminate against relatively new firms which may have earnings only in future periods, if at all. Given the social concern with industrial concentration, it would seem undesirable to discourage the formation of new business units. This may be especially important in high technology ventures in which the financial accounting requirement that R&D expenditures must be treated as current expenditures on the income statement has adversely affected the reported income of new firms. A related problem is that any deferral (or nonutilization) of the operating loss deduction lessens the impact of federal income tax incentives, such as accelerated depreciation.

The obvious solution which satisfies all of the criteria is to give corporations current tax benefit from operating losses which do not currently offset prior year's income. Because such a tax benefit will function in a manner similar to a credit, it will be referred to as an operating loss refundable credit.

The potential benefits from an operating loss refundable credit are substantial. The inequitable treatment of the flow of value and the double taxation associated with the failure to use the business deduction would be eliminated. Moreover, the discrimination against firms which only have future income against which to offset current losses would be removed. And the credit might also offer some significant benefits from a broader economic and financial perspective. By reducing the potential loss associated with an investment, the credit may stimulate the volume of new investment especially in particular risky ventures. Within a risk/return framework the credit would increase the expected return on new investment and reduce the amount of risk through narrowing the variance of expected returns; in short, the bottom tail of the probability distribution of expected returns from a new investment would be eliminated. Moreover, the credit could be used in a positive manner in order to encourage investment in specific types of businesses or in specific regions. For example, credit rates could be higher in some areas than in others. In addition, higher credit rates could be used for new business firms or for firms with sales below some specified amount. This would have the advantage of placing a floor under corporate income without increasing the returns for all firms. In addition, a credit would make more meaningful the federal tax incentives provided in accelerated deductions. Yet, the implementation of the credit would raise a number of issues, including the following:

Approach. The credit should not be elective, in order to promote simplicity in the tax laws. If the credit were not elective, it would replace the operating loss *carryforward*, and the issue of restrictions on transfer v. free transferability would disappear.

Rate. The credit rate should be set at a rate which, in the absence of special considerations, approximates the rate on taxed income (if any) which might be offset in the future. As a suggestion, the rate might be set at 15 percent on the first bracket of operating losses, at 18 percent on the next bracket, and at 20 percent thereafter. In no event should the rate be higher than the effective rate for the industry involved.

Certainly there are problems in adopting an operating loss credit. One might argue that the credit is a subsidy for "losing" operations and poor management, although the obvious counterargument is that the credit would remove a disadvantage suffered by such businesses. Further, the concept of a refundable credit has met with resistance, for example, a refundable investment credit. However, the investment credit is designed as a tax incentive, while the operating loss credit would be designed to remove an inequity, to promote simplicity, and to prevent trafficking in losses. In an environment in which concern has been raised about tax discrimination against investment and economic growth, a proposal which both reduces tax inequity and has the potential use of fostering investment has substantial merit for consideration.

FEDERAL HOME LOAN BANK BOARD
Washington, DC, July 31, 1985.

Hon. CHARLES B. RANGEL,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR CONGRESSMAN RANGEL: This statement is submitted for inclusion in the record of your Subcommittee hearing on May 22, 1985, covering changes in the limitations on net operating loss carryovers (and similar carryovers) following a corporate merger.

I would like to call your attention to a positive role which certain tax rules play in assisting government-supervised mergers of defaulted savings and loan associations. These mergers occur under the supervisory authority of the Federal Home Loan Bank Board (FHLBB) and the Federal Savings and Loan Insurance Corporation (FSLIC) to safeguard and maintain the federal deposit insurance program. This program has long protected savings and loan institutions and, most importantly, the funds which depositors have placed in those institutions. Tax benefits are not the primary reason for these mergers.

The existing tax provisions which facilitate supervisory mergers include a special rule on net operating loss ("NOL") carryovers to take into account unique features of mergers involving savings and loan associations. I refer to section 382(b)(7)(B) of the Internal Revenue Code. Because of the continuing importance of supervisory mergers of savings and loan associations to the financial economy, we believe that special treatment should be preserved in any statutory changes your Subcommittee may propose to section 382 generally.

The Economic Recovery Tax Act of 1981 (ERTA) adopted several statutory provisions which address the taxfree reorganization of troubled thrifts, NOL carryover rules, and the tax treatment of financial assistance supplied by FSLIC to weakened thrifts.[1]

The President's Tax Reform Plan proposes to continue all these ERTA rules through December 31, 1990. This continuation is welcome and is most important to the thrift industry.

However, because your Subcommittee is considering a separate revision of the NOL limitations generally, it will still be necessary to adapt the special rule for supervisory thrift mergers to whatever new approach Congress may adopt under Code section 382. My primary concern is to maintain the ability of the Bank Board, as

[1] Section 368(a)(3)(D)(ii) of the Internal Revenue Code provides basic taxfree treatment for supervisory thrift mergers. Section 597 deals specifically with the tax treatment of FSLIC financial assistance. Section 593(e) deals with repayment of FSLIC assistance.

operating head of FSLIC, to resolve the severe difficulties facing the thrift industry, and to operate at maximum efficiency.

I. IMPORTANCE OF EXISTING TAX PROVISIONS: IN GENERAL

The current tax treatment afforded thrift supervisory mergers (and contributions by FSLIC to weakened institutions) provides a highly cost-effective means for avoiding otherwise unnecessary liquidations of thrifts, reducing the current pressure on FSLIC's financial resources, and protecting depositors in insured institutions. The existing tax treatment has not, to our knowledge, been abused in any way.

The tax treatment of a supervisory merger and of FSLIC assistance are factors which FSLIC must calculate into its ultimate cost of assisting a merger. By statute, FSLIC assistance in a particular case may not exceed the cost of a liquidating payout of insurance. See 12 U.S.C. § 1729(f)(4)(A). Because of this provision, a failing thrift would have to be liquidated in a case where the cost of assistance would exceed the payment of insurance on all insured accounts. The tax treatment under ERTA helps us avert the need for otherwise avoidable liquidations by fostering supervisory mergers of failing thrifts.

Taxfree treatment of a supervisory merger—including continuation of the tax history of the insolvent or defaulted institution—means that a healthy financial institution which assumes the assets and liabilities of a defaulted institution will not encounter tax penalties. That is, the acquirer will not find that the acquired institution must recapture its earlier bad debt reserve deductions, or find its past tax history cut off, or find that, when the acquirer collects the mortgage receivables taken over in the merger, it will realize unexpected taxable income.[2] The special thrift rules prevent all these tax penalties for the sensible reason that the underlying circumstances do not call for tax obstacles to this type of reorganization. If negative tax results were to occur, FSLIC would find that no healthy institution would be willing to acquire the insolvent association, or that the acquirer would request FSLIC to reimburse the acquirer for all the negative tax results. Either of these consequences would prevent the Board from carrying out its responsiblities in an effective, efficient manner.

Supervisory thrift mergers do not present significant opportunities for "trafficking" in loss companies. Section 382(b)(7)(B) applies only in cases where the Federal Home Loan Bank Board certifies that the insutution to be reorganized is insolvent, has experienced a substantial dissipation of assets or earnings, or is in an unsafe or unsound condition to transact business. Since a thrift institution can only merged directly with another financial institution, operating losses incurred by a thrift association can only be used against income of a financial institution. In our experience over four years, these provisions have worked well and have not been abused. We at the Bank Board have been aware of the need to follow the tax requirements conscientiously. We have applied our certification authority responsibly.

It is also important to point out that financial assistance agreements are structured so that in many cases FSLIC, rather than the weakened thrift or its acquirer, obtains the benefit of tax savings produced by NOL carryovers from the merged institution. FSLIC obtains this benefit by means of provisions in the assistance agreement which credit part, or in some cases all, of the tax savings to FSLIC. These provisions reduce, in effect, the cost of financial assistance which FSLIC is obligated to provide with respect to the failing institution in connection with the merger.

II. TECHNICAL TAX FACTORS

Section 382(b)(7)(B) is valuable chiefly where an acquiring stock institution acquires the mortgages and customer deposits of a weakened association and substitutes equivalent deposit accounts in the acquiring institution, but without issuing any stock to the depositors. Shareholders, if any, of the insolvent institution usually receive no stock from the acquirer.

ERTA allowed supervisory mergers of this kind to receive taxfree reorganization treatment.

The general rule of section 382(b) provides that carryovers of the acquired corporation will survive in full if shareholders of the loss company receive stock worth at least 20% of the value of the combined enterprise after the merger. Section

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[2] "Discount income," so-called, would arise if the merger were taxable, because the tax basis of the mortgages would be reduced to current market value. Collections on the mortgages after the merger would then be transformed into taxable income when collections exceed the decreased tax basis of the mortgages.

382(b)(7)(B) allows this test to be satisfied by comparing the dollar amount of deposits in the tranferor association with total deposits of both associations after the merger. If the acquired deposits comprise at least 20% of total combined deposits, NOL carryovers survive the merger in full.

I understand that several new concepts are under consideration by your Committee and staff in connection with revising the rules under section 382. Among the alternatives are rules which would limit loss carryovers by reference to the fair market value of the loss company at the time of a merger. The Senate Finance Committee staff recently proposed limiting the availability of NOL carryovers after a change in stock ownership to an amount equal to the Federal long-term Treasury Bill rate times the value of the loss corporation immediately before the merger. Under another purchase price rule, the loss company's value would be measured by the value of the consideration paid for the loss company in cash, notes or stock.

It is difficult to apply either of these value tests to an acquired company which is insolvent or financially troubled. The Senate staff has therefore proposed that if a company is reorganized in formal bankruptcy under title 11 of the the U.S. Code, no limitations would apply to carryovers at the date of a change in control of the loss company.[3]

The comparison of deposits required by section 382(b)(7)(B) also does not fit within a value test. In my view, however, the same policy that underlies the proposed exception for bankruptcy cases should be applied to mergers of defaulted savings and loan associations. Thrift institutions are technically reorganized under special provisions of banking law.[4] For this reason they are not covered by the general provisions of federal bankruptcy law in title 11 of the U.S. Code.[5] Nevertheless, mergers of thrift associations under FSLIC supervision (or supervision by comparable state agencies) are equivalent to bankruptcy reorganizations. Similar treatment is warranted and supervisory thrift mergers should be expected from the general rule proposed by the Senate tax staff for mergers of solvent companies.

An exception of this kind will permit FSLIC to carry out its statutory responsibility to oversee financial institutions and to protect their depositors by arranging, when necessary, an acquisition of a defaulted institution by a healthy institution.

III. CURRENT ECONOMIC CONDITIONS

With regard to the industry's current condition, I must emphasize the magnitude of the task facing FSLIC. Recent rate declines have reduced the negative "spread" between the industry's cost of funds and yield on assets, which accounted for the record losses experienced by the industry in 1981 and 1982. The crisis, however, is by no means over, and FSLIC's need for maximum cost efficiencies countinues. The cumulative impact of several years of record losses has seriously eroded the capital base of the industry and has left many associations so weakened that they will continue to deteriorate regardless of further positive economic developments.

Although thrift institutions significantly increased their already large contribution to housing markets during 1984, developments during last year demonstrated the fragility of the industry's recovery, and its vulnerability to interest rate changes during the lengthy period required to restructure thrifts' balance sheets. In recent years, we have also seen the beginnings of a disturbing trend in the reasons why failing savings institutions fall onto FSLIC's doorstep. Three years ago, approximately 80% of FSLIC cases were primarily attributable to interest rate spread problems, and 20% were primarily due to asset quality problems. For 1984, that ratio reversed itself to 30–70—with the result that a substantial portion of the FSLIC's caseload is characterized by bad assets. I cannot overemphasize the importance of this shift in FSLIC's problems.

Asset quality cases have proven to be up to five times as expensive for FSLIC as interest rate spread failures.

Savings and loan managers are still in the early stages of restructuring their portfolios to avoid the huge maturity mismatches which nearly drove the industry to disaster in 1981–1982. The health of the industry over the past two years has shown relative improvement over the previous two-year period, but this improvement is primarily the result of falling interest rates and certain accounting devices which exaggerated actual operating profits.

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[3] Senate Finance Committee, Subchapter C Revision Act of 1985: A Final Report Prepared by the Staff (S. Rep. No. 99–47, 99th Cong. 1st Sess. 56, 249 (1985)).

[4] 12 U.S.C. § 1729.

[5] 11 U.S.C. § 109.

In 1984 FSLIC-insured institutions had net income after taxes (exclusive of a special preferred stock dividend paid by the Federal Home Loan Mortgage Corporation) of approximately $1.1 billion.[6] This is substantially less than the $2.0 billion income in 1983. It represents a return on assets of approximately 0.12%, compared to 0.27% in 1983.[7] This is still, of course, sharply better than the operating picture in 1981–1982, but well below the level of profitability prevailing in the late 1970s, when the industry was considered, by relative measurements, at the peak of health.

Economic developments during 1984 also point up the industry's continuing vulnerability to changes in interest rates. The annualized return on assets declined from 0.23% in the last half of 1983 to 0.16% in the first quarter of 1984 and to a meager 0.05% in the third quarter of 1984.

Despite the overall profitability of the thrift industry last year, 25% of all FSLIC-insured institutions were operating in the red for the year 1984 as whole. The ratio of regulatory net worth to total assets edged downward from 4.03% at the end of 1983 to 3.88% at the end of December, 1984. Some 29% of the industry had a ratio of regulatory net worth to total assets of less than 3%. This represents a continued decline from the 4.2% net worth ratio at the end of 1981 and from the 5.5% level in 1980.

FSLIC's reserves protect a deposit base that stood at more than $785 billion at the end of last year. By contrast, the book value of the FSLIC's reserves declined from $6.4 billion as of December 31, 1983 to slightly less than $6.0 billion as of March, 1985. This was the first time in its history that FSLIC book reserves actually declined. This decrease results from the increased demand placed on the Fund stemming from a growing number of asset quality problems at some FSLIC-insured institutions. Since December 31, 1982, almost all income received by the FSLIC has been expended to solve problem cases.

The ratio of FSLIC's reserves to insured deposits has also been rapidly approaching an historic low point. Historically, the reserve ratio (total FSLIC book reserves as a percentage of total deposits) has averaged 1.2%, peaking at 2.12% in 1970. Since then, the ratio has decreased sharply, falling from 0.92% at the end of the third quarter of 1984 to 0.76% at year end.

Of the 27 cases resolved by FSLIC during 1984, 19 were asset quality problems and only 8 were interest rate spread problems. These asset quality cases are more complex and significantly more expensive to resolve. This is especially true because, in recent months, potential acquirers of severely troubled institutions have not come forward. Potential acquirers have tended to be unwilling, for the most part, to assume the risk of large losses on bad assets. Also, potential acquirers which might otherwise have had a serious interest in gaining interstate franchise rights through supervisory mergers have applied for "nonbank bank" franchises in many states—this has reduced our pool of possible acquirers having a real interest in, or incentive for, helping FSLIC resolve its problem cases through acquisitions.

Nevertheless, FSLIC increased its efforts during 1984 to prevent thrift institution defaults. FSLIC processed 27 cases in 1984 with assets of $5.88 billion and a net present value cost of approximately $700 million. This included resolving 18 cases with assets of $4.3 billion through the assisted acquisition process. FSLIC also placed 9 institutions with assets of $1.5 billion in receivership. The cost to pay insurance on these cases is estimated to be $450 million. (Before 1983, the total number of institutions liquidated by the FSLIC throughout its entire 50-year history was only 15).

In our current budget, FSLIC estimates that its cost for assisted mergers will increase from $801 million in 1984 to $1.9 billion in 1985 and to $2.3 billion in 1986.

IV. SUMMARY

Given the current state of the industry, the policies underlying the existing tax treatment of supervisory mergers and FSLIC assistance are compelling. Actually, because the industry's condition has deteriorated since ERTA, its reforms are more justified and necessary today than they were in 1981. FSLIC anticipates that it must now provide greater financial assistance than in the past to induce stronger or healthy institutions to acquire those which have been weakened.

Continuation of a special rule for NOL and credit carryovers after a supervisory merger is important to FSLIC's ability to resolve the large problems still facing the

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[6] Figures represent actual data for the first three quarters of 1984 and estimated amounts for the fourth quarter.

[7] Even including the $0.6 billion extraordinary Freddie Mac stock dividend, net income in 1984 is estimated at only $1.7 billion (0.19% return on assets), still well below the 1983 level.

industry and to protect insured and uninsured depositors. Supervisory mergers are crucial to the health of the financial services industry and to the continued confidence of depositors in the entire banking system. Such confidence benefits the entire national economy.

Recent experiences of thrift associations in Ohio and Maryland illustrate the importance of the confidence factor.

Please contact me, or any of my staff, if we may be of further assistance to you on this matter of continuing importance to the financial industry.

Sincerely,

EDWIN J. GRAY,
Chairman.

STATEMENT OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

The National Council of Savings Institutions is pleased to have the opportunity to comment on the use of net operating loss carryovers (NOLs) in a change of control or ownership. Given the lengthy debate over the changes made by the Tax Reform Act of 1976 which have yet to be implemented, and current law treatment of NOLs, the Subcommittee's consideration of this issue is timely. It is also a needed step toward resolving uncertainties that may impede strategic planning for corporations.

We in the savings industry are concerned about the resolution of these issues because the industry is in a unique position to be affected by changes in the treatment of net operating loss carryovers. The industry is currently undergoing an unprecedented number of mergers, many of which are fostered by the federal government. Savings institutions would thus be substantially impacted by implementation of the 1976 rules on treatment of NOLs and any changes in the rules on "G" reorganizations and treatment of assistance from FSLIC which were enacted in 1981.

The National Council urges the Subcommittee to take into consideration the impact of abrupt changes in rules on mergers and treatment of NOLs on both the voluntary and supervisory mergers which will continue to be necessary to bring the savings industry back to full health. Over the past few years over 700 thrifts have undergone mergers under the auspices of the Federal Home Loan Bank Board. Additionally, a number of institutions will be merged in the future.

1976 AMENDMENTS

The National Council supports repeal of the limitations enacted by the 1976 Tax Reform Act. In general, it is our belief that any shortcomings of current law are preferable to the effect of the limitations that would be imposed on mergers, conversions and acquisitions if these provisions are allowed to become effective. While the treatment of net operating losses are *not* the primary reason that mergers and acquisitions among savings institutions take place, they are one factor among many that can make a merger more attractive. For these same reasons we are not prepared to endorse either the ABA or ALI proposals without further study. Essentially, we believe that the certainty of the present rules is the best approach at this time. We believe this because the next few years will be critical ones for the consolidation and recapitalization of the savings industry.

REORGANIZATION RULES FOR FINANCIALLY TROUBLED INSTITUTIONS

Special rules enacted in 1981 provide tax-free treatment for the acquisition of a "financially troubled" thrift. In general these rules provide that a merger under the auspices of the Federal Home Loan Bank Board (FHLBB), the Federal Savings and Loan Insurance Corporation (FSLIC) or a state authority, meet the continuity of interest requirements and that the acquiring institution succeeds to the tax attributes of the failing thrift. In addition, the 1981 law provides an exclusion from income for payments by FSLIC to a thrift institution involved in a reorganization. The Council urges continuation of these special rules under any action taken by the Subcommittee. Given the continuing need for mergers as an alternative to liquidation of troubled institutions, it is imperative that these rules remain in effect for the near future. Immediate repeal or change in these rules would increase substantially the cost to the FSLIC fund of arranging mergers of troubled institutions.

The Council also urges that the Subcommittee take action to extend identical treatment for reorganizations and assistance to thrifts under the auspices of the FDIC. Reorganizations or assistance to thrifts should be treated in a similar manner whether the reorganization is completed or assistance given under the auspices of the FSLIC or FDIC.

NOL CARRYFORWARD EXTENSION

The Council has additional concerns that relate to the treatment of NOLs. While not specifically included in the topic of these hearings, we would urge the Subcommittee to grant an extension in the NOL carryforward period available to thrift institutions. This would allow those institutions who, in cooperation with FSLIC and FDIC, acquired weak or failing thrift institutions with substantial net operating losses additional time to produce the necesary income to offset these losses. Since thrift institutions currently have only a five-year carryforward for net operating losses, many institutions find that they will in the near future reach the end of their carryforward period without having enough income to offset the total losses picked up through mergers with failing institutions. Since other businesses enjoy a 15-year carryforward, some extension of the period to cover these losses would seem reasonable.

The Council commends the Subcommittee for its thorough examination of the treatment of NOLs in reorganizations and mergers. We look forward to working with the Subcommittee in resolving current problems relating to reorganizations and mergers and the treatment of tax attributes associated with these activities.

Statement of the U.S. League of Savings Institutions* on Net Operating Loss Carryovers

SUMMARY

1. Economic conditions in the thrift industry justify continuing the existing special treatment of supervisory mergers.

2. Special treatment of net operating loss carryovers in a supervisory merger of savings and loan institutions, where an insolvent thrift institution is merged with a healthy financial institution by the Federal Savings and Loan Insurance Corporation, should be continued. The present special rule appears in Section 382(b)(7)(B) of the Internal Revenue Code, and allows depositors in the merged institution to qualify for full survival of loss carryovers after the merger.

3. If the general rules of Section 382 are revised to exempt creditor takeovers of bankrupt companies from special limitations on the survival of tax attributes, similar treatment should be given to mergers of troubled savings institutions. Supervisory mergers are analogous to bankruptcy cases, although regulated under special provisions of the National Housing Act.

4. The corporate net-operating loss carryover rules under Sec. 172 should be extended to financial institutions as a matter of equity. Depository institutions deserve parity with corporations generally in averaging income and losses over a period of years, since they too experience fluctuations in income.

INTRODUCTION

Though most savings institutions are on the road to recovery after the strains of the high interest period from 1980 to 1983, the problems of that era have not yet completely disappeared. In the early 1980s many thrifts encountered financial difficulty because of an unfavorable spread between the return on their mortgage receivables (many of which carried below-market interest rates) and the higher rates they had to pay to attract and hold deposits. Many institutions have been trying to eliminate these spread problems by disposing of low rate mortgages and replacing them with receivables carrying higher or adjustable rates of return. The task of changing an investment portfolio cannot be done overnight, however. Many institutions have not completed the job of improving their balance sheets and adjusting their expertise to the new and broadened investment powers permitted by the Garn-St Germain Depository Institutions Act of 1982.

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* The U.S. League of Savings Insitutions serves the more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions—federal- and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations and Senior Vice President; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 11 East Wacker Drive, Chicago, Illinois 60601. The Washington office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

In addition, new problems have surfaced at some institutions arising from asset quality problems in the search for higher yields commensurate with the rates needed to compete for depositors in today's largely deregulated market for savings. The recent crisis at the state insurance level in Ohio and Maryland indicate continued problems of this latter kind.

Lower interest rate levels have had an extremely beneficial impact on savings institutions and have actually enabled many of them to make a conscious decision to forgo current profits in return for better insulation in the future from rate swings. In 1984, FSLIC-insured institutions had net income after taxes of only approximately $1.5 billion according to preliminary data. This is substantially less than the $2.0 billion income in 1983 and represents a return on assets of approximately 0.16%, compared to 0.27% in 1983. Though 1985 should produce easily the best earnings level since 1979, the entire thrift industry still remains vulnerable to upward changes in interest rates despite our best efforts to speed the restructuring process.

This continuing thrift vulnerability raises concerns and focuses attention on the size and adequacy of the deposit insurance funds—the Federal Savings and Loan Insurance Corporation, in the case of most savings institutions and the Federal Deposit Insurance Corporation in the case of many traditional savings banks. These federally-backed insurance funds are critical to protecting existing thrift depositors as well as bolstering overall public confidence in the U.S. financial system. Maintaining such confidence is, in turn, a key element in restoring financial health to the national economy as a whole.

The special provisions in the tax code for supervisory mergers have been an important help to our federal insurance fund—the FSLIC—in dealing with troubled thrift cases. The U.S. League strongly supports retention of these existing Federal income tax provisions which have helped protect innocent depositors and have maintained public confidence in savings institutions.

Background: 1981 amendments

For thrift institutions whose depositors are protected by federal deposit insurance, federal banking law empowers the Federal Savings and Loan Insurance Corporation (FSLIC), in the case of savings and loan associations—and the Federal Deposit Insurance Corporation, in the case of savings and commercial banks—to exercise supervisory authority when the insurer anticipates that an institution may be nearing a state of default on its accounts or has already fallen into default. Under these oversight provisions [1] FSLIC may, in its discretion, make loans to an insured institution, buy some of its assets, agree to make various types of financial contributions or, if necessary, assume managerial control and merge the institution with another insured institution which will agree to assume the assets and liabilities.

If any of these steps cannot be taken or will not restore a sound, solvent condition. FSLIC may liquidate the institution in an orderly manner, pay off the insured depositors and manage the remaining corpus to produce the best return for any insured creditors.

In exercising its powers, it is common in merger cases for FSLIC and the acquiring institution to enter into a financial assistance agreement specifying that FSLIC will provide various types of financial assistance to the acquirer in helping it work out problems with the assets it agrees to assume.

In order to supplement these supervisory powers, the Economic Recovery Tax Act of 1981 (ERTA) included a number of amendments to the Internal Revenue Code adapting certain unique features of savings and loan associations to the tax free reorganization rules of the tax law. ERTA also dealt with similar technical concerns in the related areas of (a) carryover of the tax history of the troubled thrift to its merger partner, and (b) the tax treatment of financial assistance supplied by FSLIC to the combined institutions after a supervisory merger.[2]

In a supervisory case, the tax history of the troubled institution, including bad debt reserves, its earnings and profits account, and its operating loss and tax credit carryovers, are inherited by the acquiring institution under rules that apply to reorganizations generally. (Section 381, Internal Revenue Code.) For purposes of the special limitations on loss and credit carryovers in section 383, ERTA adopted a special rule that in a FSLIC-supervised merger, depositors in the transferor association will

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[1] See section 406(f) of the National Housing Act, 12 U.S.C. section 1729(f).

[2] Section 368(a)(3)(D)(ii) of the Internal Reveune Code deals with basic tax free treatment of a supervisory thrift merger under the reorganization provision. Section 597 deals with the tax treatment of FSLIC financial assistance to the receiving institution. Section 593(e) deals with repayment by an institution of FSLIC assistance.

be deemed to be shareholders for purposes of applying the 20 percent rule of section 382(b). (Section 382(b)(7)(B), Internal Revenue Code.[3])

Because of the continuing importance to the financial economy of supervisory mergers of savings and loan associations, the U.S. League of Savings Institutions believes that special treatment should continue to be given to supervisory mergers if this subcommittee proposes changes to section 382 generally. It is our strong belief that the existing tax rules for supervisory mergers are, and have been, consistent with basic reorganization policies in our tax law: that these provisions are accomplishing the purposes for which they are enacted in 1981: and that the provisions are still needed to help the federal and state oversight agencies protect the interests of depositors and promote public confidence in the banking system.

Basic rationale for tax free treatment of supervisory mergers

A number of features of supervisory thrift mergers should be discussed in order to evaluate the merits of the special depositor rule in Section 382(b)(7)(B). The first factor is that in allowing a supervisory thrift merger to qualify for tax free reorganization treatment. Congress decided in 1981 that it should not be material whether the acquiring institution agrees to issue shares of its own stock in exchange for the deposit liabilities it agrees to assume. The problem arises because there are two basic types of savings institution reorganizations: those that operate in mutual form and those that operate in stock form. A mutual association has no shareholders in the conventional sense. Its depositors are both creditors of the mutual association and owners of residual rights to assets and the owners of essentially all voting rights in some cases, mortgage borrowers may also be given one vote per outstanding loan. Since savings and loan associations rarely liquidate as a practical matter, the "equity" rights represented by depositors' accounts in a mutual association have been designated by the Internal Revenue Service as more nominal than real. (In cases of conversion from mutual to stock form, however, these rights of the depositor are recognized under Federal Home Loan Bank Board rules applying to all FSLIC-insured institutions by the grant of preemptive subscription rights to the conversion stock to the depositors of the converting institutions.) Nevertheless, the Internal Revenue Service has ruled that a merger between two mutual savings and loan associations may qualify as a tax free reorganization (Rev. Rul. 69-3, 1969-1, C.B. 103).

If FSLIC were to arrange a supervisory merger of a troubled mutual association into a healthy mutual thrift, the tax free treatment of the merger would have been fully covered by Rev. Rul. 69-3 and no special legislation would have been needed in 1981. It would have been necessary, however, to clarify the loss carryover rules in section 382 in order to deal with the unique dual status of a depositor in a savings and loan association. The original language of section 382 did not deal with the hybrid characteristics of a deposit account in a thrift institution.

If the tax free reorganization provisions had not been expanded in 1981, the class of potential acquirers for troubled institutions in a FSLIC-supervised transaction would be limited to mutual associations. Many supervisory mergers have involved merging an insolvent mutual or stock association into a healthy stock association. In these cases, the acquiring association agrees to assume the assets and liabilities of the troubled association and to replace the depositors' accounts with new accounts of equal value in the acquirer. Shareholders, if any, of the transferor usually receive no consideration. And no new stock is issued to any depositors of the merged institution. Congress felt in 1981 that the range of potential acquirers available to FSLIC should not be limited by the technical distinction between a mutual and a stock association.[4]

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[3] Section 382(b) requires generally that, in order for loss and credit carryovers to survive in full, shareholders of the loss company must receive stock worth at least 20 percent of the value of the acquiring company after the merger. If this threshold is not attained, carryovers are reduced by 5 percentage points for each one percentage point below 20 represented by the stock issued to the loss company's shareholders in the merger.

Section 382(b)(7)(B) adapts this concept to supervisory mergers. It deems depositors in the defaulted or insolvent institution to the shareholders in applying the 20 percent rule. Accordingly, the deposit accounts assumed by the acquiring institution are to be compared with aggregate deposits in the combined institution after the merger. If the assumed deposits equal at least 20 percent of the combined aggregate deposits, loss and credit carryovers of the defaulted institution survive in full. To the extent the 20 percent threshold is not attained, carryovers are scaled down proportionately under the formula described above.

A supervisory merger also has the unique feature that depositors in the merged institution do not want to transform their deposit assets into stock certificates. Deposit accounts are inherently intended to be government insured and redeemable at maturity. This factor distinguishes a thrift merger from a conventional bankruptcy situation, where the troubled company lacks cash to repay its creditors, or an acquiring business may not have enough cash to repay all the creditors dollar-for-dollar. Consequently, the creditors in those cases will typically agree to accept stock in hopes of being able to sell the stock for cash at a later date. By contrast, depositors in a savings and loan association want cash available under the terms of their deposit arrangement. A supervisory merger substitutes for the liquidating payout of federal account insurance by providing depositors in the transferor association with new accounts representing the exact same amount, in cash, as their old savings accounts. This is a unique feature of a deposit account in a financial institution. This special feature explains why Congress custom-tailored a rule for tax treatment even if the acquiring institution issues no stock to the depositors of the defaulted institutions.

Tax benefits credited to FSLIC

A second factor in understanding the significance of the special loss carryover rule enacted in 1981 is that, by statute, the cost of FSLIC assistance in a supervisory merger may not exceed the cost of a liquidating payout of insurance. (See 12 U.S.C. Section 1729(f)(4)(A)). A failing thrift institution would, therefore, have to be liquidated if the cost of FSLIC assistance in the merger would exceed the payment of insurance on the insured accounts. The tax treatment of a supervisory merger is a factor which the FSLIC builds into its ultimate cost calculation of assisting a merger. Because of these statutory provisions, the tax treatment under ERTA helps the government agency avert an otherwise unavoidable liquidation.

FSLIC assistance agreements are structured so that in many, if not most, cases, FSLIC—rather than the insolvent association or its acquirer—obtains the benefit of tax savings produced by net operating loss carryovers from the merged institution. Normally, the financial assistance agreement contains detailed provisions which require that tax savings realized by the acquirer from use of operating loss or tax credit carryovers must be applied to reduce the amounts of monetary assistance which will be provided to the acquiring association.

Thus, allowing the normal flow of tax attributes in a supervisory merger reduced the cash flow and reserve drain on the FSLIC insurance fund that would result if the transferor could not have been merged at all and its depositors were paid the full amount of their accounts from the deposit insurance fund.

No abuse potential

The loss carryover rule in Section 382(b)(7)(B) does not lend itself to abuse because supervisory thrift mergers do not contain the potential for "trafficking" in loss companies. In order for a supervisory case to qualify for the carryover of operating losses and tax credits, the tax law sets forth a number of protections. First, the Federal Home Loan Bank Board must certify that the institution to be reorganized is insolvent, has experienced a substantial dissipation of its assets or earnings, or is in an unsafe or unsound condition to transact business. In addition, the healthy institution must acquire substantially all the assets and liabilities of the troubled institution. (It is not sufficient to acquire only part of the asset base, or to acquire assets without also assuming the full range of liabilities. Though a number of assistance agreements of the purchase and assumption form, whereby the FSLIC retains the assets of the failing institution and only the deposit liabilities are transferred to another institution in return for a FSLIC cash payment, have been concluded recently, these transactions do not fall under the special reorganization provisions and thus, by definition, cannot abuse these special rules.) The Bank Board certification must determine that the troubled institution did not intentionally deplete its assets or endanger its operations for the purpose of qualifying for tax free treatment. Finally, the anti-tax avoidance provisions of section 269 of the Code continue to apply in any case where the facts establish that an acquiring institution agreed to merge with a troubled institution primarily for tax benefits.

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[4] Congress expressed this policy quite clearly:

"The Congress concluded that the tax laws should be modified to facilitate providing of financial assistance by the FSLIC and mergers of financially troubled institutions into stronger institutions. Specifically, the Congress believed that the merger of financially troubled institutions into stronger organizations should be allowed without regard to the continuity of interest rules."

Staff of the Joint Committee on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, p. 151, 152 (December 31, 1981)

Furthermore, a savings institution can only be merged directly with another depository institution. Therefore, operating losses and credit carryovers incurred by a savings association can only be used against future income produced by the operations of another financial institution. There are rules in the tax law which prevent losses from being used to offset income produced by the operation of a commercial business. There are also statutory restrictions (in both tax law and banking law) on the kinds of assets which a financial institution may own. Here, it is not possible for a commercial business, which might own and operate an acquired savings institution as a controlled subsidiary, to transfer assets from the commercial business to shelter taxes on business profits through loss carryovers from the savings institutions.

The U.S. League of Savings Institutions believes that in the four years during which the special loss carryover rule has been in effect, it has worked as it was intended and has not been abused.

Changing the general approach under section 382

We understand that several new concepts are under consideration by the Select Revenue Measures Subcommittee staff in connection with a possible general revision of the rules under Section 382. Among the alternatives, we understand, are rules which would limit loss carry overs by reference to the value of the loss company at the date of merger, or that carryovers might be allowed only up to an imputed rate of return on that value after a merger.

At the same time, we understand that staff consideration has been given to a rule that if a corporation is reorganized in a former bankruptcy under Title II of the U.S. Code, no such limitations would apply to carryovers when creditors obtain stock in a reorganized company.

We believe there is considerable merit in an exception for bankruptcy cases. The same policy that supports an exception of this kind should also apply to supervisory mergers of savings institutions. Just as it would be difficult to find positive value in an insolvent company, where liabilities exceed assets, it is equally difficult to apply a value limitation to a supervisory merger in the savings and loan area without extinguishing the carryovers completely.

The U.S. League would be glad to work with the Committee staff to develop a workable exception for supervisory mergers consistent with the exception under consideration for conventional bankruptcy cases.

NOL carryforward rules for financial institutions should match corporations

In this general area of dealing with the fall-out from the difficult economic and competitive conditions facing savings institutions over the past few years, a few other considerations are also worthy of attention by the tax writing committees.

The first is a previous IRS position that acquiring institutions in any merger, supervisory or not, would lose the tax free reorganization status if over 50% of the mortgage portfolio of the acquired institution were subsequently sold. Though this position has softened recently, we would hope that Congress would indicate that this position should not be raised again as a threat to the tax treatment of savings institution mergers. In fact, the problem is indicative of the special consideration that is needed in dealing with the particular problems arising at savings institutions making the transition to a deregulated environment.

More pressing is the problem of net operating loss carryovers at financial institutions. This problem can arise even for institutions which have not completed any merger transactions during the past few difficult years, but is particularly acute for acquiring institutions many of whom have relieved considerable pressures on the FSLIC by averting costly liquidations.

Sales of assets acquired in the merger can often produce significant tax losses. In many instances institutions are put in a tax loss carryforward mode but do not have the benefits of the normal 15-year corporate carryforward period. In 1981 the Economic Recovery and Tax Act changed the net operating loss carryover rules for normal corporations by extending their carryover period to 15 years while the loss carryforward for financial institutions remained unchanged with only a 5-year carryover period. The reason given for the shorter 5-year carryover period for financial institutions was their favorable 10-year carryback authority. However, this special 10-year carryback authority was provided by Congress in the Tax Reform Act of 1969 in recognition of the significant risks and potential losses borne by long-term residential lenders. This loss provision was described in the words of the House Ways and Means Committee as "proper protection of the institution and its savers in light of the peculiar risks of long-term lending on residential real estate. . . .".

Another reason for special thrift NOL carryback treatment was to offset a 33.3% phase-out in the thrift bad-debt reserve benefit (Sec. 593) also required by the 1969

Tax Act. Then, in 1978, the IRS—without any congressional or judicial approval—issued a regulation (1.593–6A(b)(5)(vi)) requiring that when an NOL is carried back, the tax base for computation of the savings institution's bad debt reserve allowance in the prior profitable year must be reduced to reflect the amount of the carryback loss. This IRS change effectively diminished our tax refund benefit by 40%.

Additionally, in 1979, the IRS accelerated the change by providing that recomputation would be required for losses carried back *from* taxable years beginning in 1979 rather than starting in 1988 as originally proposed. Consequently, at a time when real protection for long-term residential lenders was needed in the early 1980s, the IRS substantially undermind by regulation the net operating loss carryback benefits for savings institutions.

The 10-year NOL carryback was never a thrift loophole but was merely intended to cushion the shock of potential extraordinary losses for long-term lenders. The thrift industry certainly incurred such extraordinary losses in the early 1980s. Even with this diminished NOL carryback provision, the thrift industry was protected from depleting its net worth more rapidly and suffering increased institutional failures.

Last November in the discussion draft commonly referred to as Treasury I, it was suggested that financial institutions be shifted to normal corporate net operating loss rules allowing a 15-year carryover and a 3-year carryback. The U.S. League supports allowing financial institutions to carry their NOLs forward 15 years for use against future income. However, we also recommend that in moving to normal corporate NOL rules, a gradual transition be provided to ease the impact of losing the 10-year carryback authority. Of equal importance with a gradual NOL corporate phase-in is protection of an institution's existing losses by allowing them to be treated under thenew NOL rules. This was done in the 1981 ERTA Act when corporate NOLs going back to 1976 were granted treatment under the new rules. If NOLs from healthy corporations were protected under the 1981 ERTA Act certainly the troubled thrift industry should be given similar treatment as a matter of equity.

CONCLUSION

Given the current problems still facing the thrift industry, the rationale for the policies underlying the tax treatment of supervisory mergers and FSLIC assistance remains strong. The tax provisions dealing with supervisory mergers are actually as useful today as they were in 1981.

In attracting strong and healthy merger partners, it is more important than ever not to create unnecessary tax obstacles, and not to repeal tax provisions which have the effect of preventing expensive liquidations of insured institutions *and* reducing the cost of FSLIC asssitance where a supervisory merger can be arranged.

The net operating loss carryover rules for supervisory mergers are an important part of the framework in which supervisory mergers occur. The U.S. League beleives that the important economic policies promoted by Section 382(b)(7)(B) should be preserved in any revision of Section 382 loss rules. The U.S. League thanks the Select Revenue Measures Subcommittee for the opportunity to present its views on this important issue.

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